

SUMMARY OF H.R. 13270, THE TAX REFORM  
ACT OF 1969

(AS PASSED BY THE HOUSE OF  
REPRESENTATIVES)

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PREPARED BY THE STAFFS  
OF THE  
JOINT COMMITTEE ON  
INTERNAL REVENUE TAXATION  
AND THE  
COMMITTEE ON FINANCE

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(NOTE.—This document has not been reviewed by the committee.)



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**P A R T 1**  
**OUTLINE SUMMARY OF PROVISIONS**

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(1)



## PART 1

### OUTLINE SUMMARY OF PROVISIONS

The provisions included in H.R. 13270 can be briefly summarized as follows:

#### I. Tax Reform Provisions

1. *Private Foundations.*—The permissible activities of private foundations desiring to preserve the benefits of tax exemption, as well as the tax benefits to their contributors, are substantially tightened to prevent self-dealing between the foundations and their substantial contributors, to require the distribution of income for charitable purposes, to limit their holdings of private businesses, to give assurance that their activities are restricted as provided by the exemption provisions of the tax laws, and to be sure that investments of these organizations are not jeopardized by financial speculation. In addition, these private foundations are called upon to make a small contribution,  $7\frac{1}{2}$  percent of their investment income, toward the cost of government.

2. *Tax Exempt Organizations, Generally.*—The activities of exempt organizations generally are limited so that they cannot participate in debt-financed leaseback operations, wherein they, in effect, share their exemption with private businesses. Second, the unrelated business income tax is extended to virtually all tax-exempt organizations not previously covered by this tax, including churches. Third, the bill extends the regular corporate tax to the investment income of tax-exempt organizations set up primarily for the benefit of their members, such as social clubs, fraternal beneficiary societies, etc.

3. *Charitable Contributions.*—Charitable contribution deductions are substantially restructured. The general charitable deduction limitation is increased to 50 percent but the so-called unlimited charitable deduction is phased out over a 5-year period. The extra tax benefits derived from charitable contributions of appreciated property, are restricted in the case of gifts to private foundations, gifts of ordinary income property, gifts of tangible personal property, gifts of future interests, and in the case of so-called bargain sales. Also, the 2-year charitable trust rule is repealed and a number of changes are made limiting charitable contribution deductions where there are gifts of the use of property and in the case of charitable remainder and charitable income trusts.

4. *Farm Losses.*—The deduction of farm losses is restricted in the case of those with farm losses of \$25,000 or more and with incomes of over \$50,000 from nonfarm sources. Other provisions of the bill, primarily relating to farm operations, provide for the recapture of depreciation upon the sale of livestock, the extension of the holding period for livestock, and a revision of the treatment in the case of hobby losses.

5. *Interest Deductions.*—The deduction of interest on funds borrowed to carry investments is generally limited to investment income plus \$25,000.

6. *Moving Expenses.*—Moving expense deductions are allowed when changing jobs for househunting trips, for temporary living expenses prior to locating a new home, and for the expenses of selling an old home or buying a new one.

7. *Limit on Tax Preferences.*—In those cases where tax preferences are not fully subject to tax, provision is made for a minimum tax on individuals having tax preferences in excess of their taxable income. The additional tax in this case is determined by adding to the regular income subject to tax, one-half of the tax preferences but only to the extent they exceed the regular income.

8. *Allocation of Deductions.*—Where taxpayers have substantial tax-free income, provision is made to allocate itemized personal deductions between this tax-free income and the individual's taxable income.

9. *Income Averaging.*—The income averaging provision of present law is substantially simplified and also made more generally available.

10. *Restricted Stock.*—In the case of so-called restricted stock plans, the interest in the property is taxed at the time of receipt, unless there is a substantial risk of forfeiture. In the latter event, the value of the property is taxed when the possibility of forfeiture is removed.

11. *Deferred Executive Compensation.*—Other deferred executive compensation is, in general, subject to tax rates as if taxed when earned, although the tax is not payable until the income is received.

12. *Multiple Trusts.*—In the case of accumulation trusts (including multiple trusts), the beneficiary, generally, is to be taxed on the distributions in substantially the same manner as if he had received these amounts of income when they were earned by the trust (taking into account any taxes paid by the trust on the income.)

13. *Corporate Mergers.*—In the case of corporate mergers, a number of changes are made. The principal change establishes tests to be used in determining when amounts cast in the form of "debt" have sufficient characteristics of "equity" to be denied the deduction of interest, where this so-called "debt" is used in the acquisition of other companies. Included among the other provisions is one which limits the availability of the installment method for reporting gains, where the debt can be readily traded on the market, and also where the installment payments are not spread relatively evenly over the period during which part of the debt is outstanding. Other restrictive changes are also made in the case of original issue discount and premiums paid on the repurchase by a corporation of its indebtedness which is convertible into its own stock.

14. *Multiple Corporations.*—Multiple surtax exemptions in the case of related corporations are withdrawn over an 8-year period.

15. *Stock Dividends.*—The rules applicable in determining when stock dividends become taxable are revised generally to provide for taxation where one group of stockholders, directly or indirectly, receives a disproportionate distribution in cash while the interests of the other shareholders in the corporation are increased.

16. *Foreign Tax Credit.*—The foreign tax credit is revised in two respects. First, it is provided that where losses of a corporation op-

erating abroad are offset against domestic income (either of the same corporation or as the result of filing a consolidated return), subsequent earnings from the foreign operations to the extent of one-half of these earnings remaining after foreign tax, are to be recaptured until the tax benefit for the domestic operations derived in the case of the initial offset of the foreign losses is recovered. Secondly, a separate limitation under the foreign credit is provided in certain cases with respect to foreign mineral income.

17. *Commercial Banks*.—The tax advantages of commercial banks, relating to special reserves for bad debt losses on loans and to capital gains treatment for bonds held in their banking business are withdrawn.

18. *Mutual Savings Banks and Savings and Loan Institutions*.—The tax treatment of mutual savings banks and savings and loan associations is revised to reduce a series of tax advantages presently available to these financial institutions.

19. *Depreciation in Case of Regulated Industries*.—Action is taken generally to limit the depreciation which may be taken in the case of certain regulated industries, to straight line depreciation unless the appropriate regulatory agency permits the company in question to take accelerated depreciation and “normalize” its tax reduction. However, in the case of existing property, no faster depreciation may be taken than is presently taken. Companies already on “flow through” may not change without permission of their regulatory agencies.

20. *Use of Depreciation in Computing Earning and Profits*.—In computing earnings and profits—which determine whether dividends are taxable or not—corporations are required to make the computation on the basis of straight line depreciation. As a result, this tax benefit cannot be passed on to stockholders.

21. *Capital Gains of Corporations*.—The alternative capital gains tax on corporations is increased from 25 to 30 percent.

22. *Depletion, etc.*—The percentage depletion rate for gas and oil wells is reduced from 27½ percent to 20 percent. Other depletion rates are comparably reduced (with five minor exceptions). Percentage depletion also is eliminated with respect to foreign oil and gas wells. Additionally, carved out production payments, as well as retained production payments (including ABC transactions) are treated as if they were loans, or the sale of property subject to a mortgage. The effect of this generally is to prevent such payments from artificially increasing the percentage depletion deduction and foreign tax credits or giving rise to income which can offset net operating losses. In addition, this eliminates the possibility of buying mineral property with money which is not treated as the taxable income of the buyer. Finally, recapture rules are applied to certain mining exploration expenditures to which the rules of present law are inapplicable.

23. *Capital Gains*.—Capital gain and loss treatment is revised in several respects. First, the alternative capital gains tax for individuals was repealed, with the result that in the case of those in the top tax brackets, the rates may rise to as much as 35 percent (or 32½ percent under the new rate structure provided by this bill); second, long-term capital losses of individuals are reduced by 50 percent before being

available as an offset against ordinary income; third, the offset against ordinary income in the case of husbands and wives filing separate returns is limited to \$500 for each or to the same aggregate amount as if they filed a joint return; fourth, the sale of papers by a person whose efforts created them, or by a person for whom they were produced, is to give rise to ordinary income; fifth, the holding period for capital gains is increased from 6 months to 12 months; sixth, employers' contributions to pension plans when paid out as a part of a lump-sum distribution, is to be taxed as ordinary income; seventh, life interests are not to be accorded a cost basis when sold; eighth, casualty losses and gains are to be consolidated in determining whether they give rise to ordinary loss or to gain which is consolidated with other section 1231 gains or losses; and ninth, transfers of franchises are not to be treated as giving rise to capital gains if the transferor retains significant rights.

24. *Real Estate Depreciation.*—Real estate depreciation is revised in several respects. The 200-percent declining balance (or sum-of-the-years-digits) method is limited to new housing; other new real estate is limited to 150-percent declining balance depreciation; and all used property is limited to straight line depreciation. However, 5-year amortization is allowed for certain rehabilitation expenditures on low-cost rental housing. Finally, the so-called recapture rules of present law, in the case of real estate, are revised so that they apply to depreciation in excess of straight line depreciation. In other words, upon the sale of property, depreciation in excess of straight line will be recaptured at that time by converting the capital gain to ordinary income to the extent of this excess.

25. *Cooperatives.*—The tax treatment of cooperatives is revised to require patronage dividends and per-unit retains to be revolved out over a period of no more than 15 years. In addition, the required cash payout in any year, on either current or prior years' patronage, must equal at least 50 percent of the amount of the current year's patronage (taking into account the 20 percent which under present law must be paid in cash on the current patronage).

26. *Subchapter S Corporations.*—In the case of subchapter S corporations (that is, the corporations treated somewhat like partnerships) amounts set aside under qualified pension plans for shareholder-employee beneficiaries may not exceed 10 percent of the compensation paid or \$2,500, whichever is smaller.

27. *State and Municipal Bonds.*—State and local governmental units are given an opportunity to issue taxable obligations and in turn receive from the Federal Government a payment equal to between 30 and 40 percent of the interest yield of the bond (on issues brought out after 5 years, the payment will be between 25 and 40 percent). Additionally, the interest on so-called arbitrage bonds of State and local governments are denied Federal income-tax exemption.

## **II. Extension of Surcharge and Excises, Termination of Investment Credit, and Certain Amortization Provisions (Contained in H.R. 12290 but Which Have Not Yet Passed the Senate, and Which Are in H.R. 13270)**

1. *Surcharge*.—The income-tax surcharge at a 5-percent rate is extended by this bill from January 1, 1970, through June 30, 1970.

2. *Excises*.—The present excise taxes on communications services and automobiles are extended for one more year and future reductions of these taxes are postponed.

3. *Investment Credit*.—The 7-percent investment credit is repealed.

4. *Pollution Control*.—Five-year amortization is provided for pollution control facilities.

5. *Railroad Rolling Stock*.—Seven-year amortization is provided for railroad rolling stock, other than locomotives.

## **III. Adjustments of Tax Burden for Individuals**

1. *Standard Deduction and Maximum Standard Deduction*.—Over a 3-year period the standard deduction is increased from 10 percent to 15 percent and the maximum standard deduction is increased from \$1,000 to \$2,000. This rate and amount are effective for 1972 and later years. In 1970 the percentage is 13 percent and the maximum, \$1,400. In 1971 the percentage is 14 percent and the maximum, \$1,700.

2. *Minimum Standard Deduction and Low-Income Allowance*.—The minimum standard deduction is increased to a level of \$1,100, by adding to the present minimum what is called a low-income allowance. This amount is phased out for the income levels above the taxable levels. This phaseout, however, is used for only 1 year. After 1970 the full \$1,100 allowance will be available for all taxpayers whose standard deduction without regard to the minimum is not in excess of \$1,100.

3. *Top Rate on Earned Income*.—In the case of earned income, a maximum rate of tax of 50 percent is provided. This is a maximum marginal rate, with the result that no earned income will be taxed at a rate in excess of 50 percent.

4. *Tax Treatment of Single Persons*.—Single persons, 35 years of age or more, and persons whose spouse has died, are provided income tax rates which are halfway between those available to married couples and those previously available to these single persons. This intermediate tax rate treatment is the category formerly known as head-

of-household treatment. In addition, in the case of widows and widowers with dependent children, age 19 or less or attending school or college, full income splitting is to be available.

5. *Rates.*—In 1971 and 1972 tax rate reductions aggregating slightly over \$2.2 billion in each year are provided. The 1972 rates provide slightly over a 5-percent reduction for those whose income levels are above the levels where the low-income allowance and increase in the standard deduction provide substantially greater reductions.



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## **PART 2**

### **ANALYSIS OF PROVISIONS AND ARGUMENTS FOR AND AGAINST**

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As requested by the Committee, the following summary includes arguments which might be raised in support of, or in opposition to, each provision contained in the House-passed bill.

This listing of the arguments for and against the features of the House bill is not intended, and indeed it cannot be, all inclusive. The many different situations which the bill affects make it impossible to anticipate every attitude that might be expressed with respect to the bill. However, it is believed that the principal positions are reflected in the summary. The order in which the arguments are presented should not be interpreted as a ranking of their importance, nor should the phraseology indicate that the staffs have any position with respect to them.



## PART 2

### ANALYSIS OF PROVISIONS AND ARGUMENTS FOR AND AGAINST

#### A. Private Foundations

##### 1. Tax on Investment Income

*Present law.*—Although present law subjects many exempt organizations to taxation on unrelated business income, investment income is specifically excepted from this tax.

*Problem.*—Heavily endowed foundations have substantial income that is not taxed. Questions have been raised as to why these private foundations should not pay some of the cost of government since they are able to pay. Also funds are needed for more and more extensive and vigorous enforcement of the tax laws relating to foundations. A user fee is needed to provide funds for this purpose.

*House solution.*—The bill imposes a tax of 7½ percent on a private foundation's net investment income (interest, dividends, rents and royalties) and its net capital gains. Deductions are allowed only for expenses paid or incurred in earning that income and for net capital losses. Taxes are not imposed upon their receipt of contributions or grants.

*Arguments For.*—(1) Since private foundations enjoy the benefits of Government as do other entities and individuals, they should bear some portion of the costs of Government, just as do other organizations and individuals.

(2) The administrative machinery necessary to insure that private foundations currently distribute their funds for proper charitable purposes is becoming more and more costly. This tax will defray a portion of that cost. It is a modest levy which will not hamper the operation of private foundations.

(3) Such a tax should encourage greater reliance upon the public than upon the one-time beneficence of one individual or family.

(4) Investment income of most other charitable organizations is not subject to tax (except for income from debt-financed acquisitions and investment income of social clubs, fraternal beneficiary societies, and certain employee insurance associations discussed below), and it is unfair to single out foundations for this special tax.

*Arguments Against.*—(1) Since the advent of our taxing statutes, the Government has recognized the special place that private foundations occupy in our society and has granted them tax-exempt status. This tax is an incursion into that philosophy and seriously undermines it.

(2) This tax will fall heavily upon those private foundations who have a profitable investment portfolio, and would reduce the fund that would be available for charitable purposes.

(3) The foundation that secures more current income for current charitable benefits will be liable for a greater tax than a foundation which does the minimum that the bill requires, and so the bill discourages good foundation management.

## 2. Prohibitions on Self-Dealing

*Present law.*—Under present law, no part of the net earnings of private foundations and other charitable organizations are permitted to inure to the benefit of private shareholders or individuals. Also, arm's-length standards are imposed with regard to loans, payments of compensation, preferential availability of services, substantial purchases or sales, and substantial diversions of income or corpus to (or from, as the case may be) creators (of trusts) and substantial donors and their families and controlled corporations. The only sanctions provided are loss of exemption for a minimum of one taxable year and loss of charitable contributions deductions under certain circumstances.

*Problem.*—Arm's-length standards have proved to require disproportionately large enforcement efforts, resulting in sporadic and uncertain effectiveness of the provisions. Moreover, the subjectivity involved in applying such standards has occasionally resulted in the courts refusing to uphold sanctions, especially when they are severe in relation to the offense. In other cases, the sanctions have practically no deterrent or punitive effect even where there is vigorous enforcement. Also, many benefits may be derived by those who control a private foundation even though they deal completely at arm's-length.

*House solution.*—The bill replaces the arm's-length standards with a list of specific prohibited self-dealing transactions. A violation of the provisions results in a tax on the self-dealer of 5 percent of the amount involved in the violation. If the self-dealing is not corrected within an appropriate time, then a tax of 200 percent of the amount involved is imposed upon the self-dealer. Similar taxes at lower rates are imposed upon the foundation manager who is knowingly involved in the self-dealing or who refuses to correct the self-dealing but the tax on the manager may not exceed \$10,000. A third level of tax is available, as described below in Change of Status. The bill also requires that the foundation's governing instrument must prohibit it from engaging in the self-dealing transactions described in the Code.

*Arguments For.*—(1) The provisions of the present Internal Revenue Code which relate to self-dealing in private foundations have proved to be totally ineffective. Abuses have arisen where individual taxpayers have benefited by using the tax-exempt private foundation for their own purposes, rather than for the charitable purpose for which the foundation was ostensibly founded.

(2) The arm's-length tests set forth in the present Internal Revenue Code are vague, and difficult to enforce. The result is that there is excessive litigation where, because of the difficulty in tracing the transaction involved, the Government is at a tremendous disadvantage.

(3) The fact that, in relation to the particular offense, present sanctions may be inordinately severe causes the courts, as well as the Internal Revenue Service, to refrain from invoking them even though there may be self-dealing. Under the bill the sanctions are properly proportioned to the amount involved in the improper transactions and are imposed upon the self-dealer rather than the foundation.

(4) The bill improves on the present law by including in the self-dealing provisions transactions between private foundations and Government officials.

(5) The highest fiduciary standards require as a practical matter that self-dealing be not engaged in, rather than that arm's-length standards be observed. These proposals are intended to impose the highest standard since experience has shown that lesser standards are too tempting to many donors and managers.

(6) The requirements as to foundation governing instruments will facilitate effective State enforcement of State common law and statutory regulation of funds dedicated to charitable purposes.

*Arguments Against.*—(1) Many innocent transactions will be subject to sanctions under the bill. Innocent transactions discovered years later may not be able to be effectively undone, especially where the foundation and the donor no longer have the property that was involved.

(2) The restrictions imposed upon dealings between the foundation and substantial contributors may well discourage persons from giving to private foundations if they have widespread business activities.

(3) In many cases, the first-level sanctions will be insufficient to deter self-dealing transactions which are deliberate and will be excessive in the case of self-dealing transactions that are inadvertent.

(4) The attribution rules are so broad that many private foundations will not be able to operate effectively because so many of those whom they would naturally deal with are or may be disqualified persons. In reply to this point it is noted that many of the present difficulties arise precisely because foundations "naturally" deal with their donors and their donors' businesses.

(5) This provision would prohibit fair and equitable transactions even where they benefit charity. In addition, it seems unfair to prevent a donor from dealing with his foundation on the same terms that the foundation would be willing to deal with an unrelated person.

(6) Rather than have any Federal prohibition on self-dealing, which is cumbersome and difficult to administer, the jurisdiction of the problem is better left to the State courts which have a wider range of remedies for dealing with the abuses, such as the removal of the fiduciaries, the mandatory distribution of income for charitable purposes, surcharge, and reformation.

### 3. Distributions of Income

*Present law.*—A private foundation loses its exemption if its aggregate accumulated income is unreasonable in amount or duration for its charitable purposes.

*Problem.*—Under present law, if a private foundation invests in assets that produce no current income, then it need make no distributions for charitable purposes, even though the donor has received full deductions for the value of the nonincome-producing property he has contributed. Also, current distributions are not required until the accumulated income becomes "unreasonable". Finally, the sanctions under present law (as described above under "self-dealing") tend to be either largely ineffective or else unduly harsh.

*House solution.*—The bill provides that a private foundation must distribute all its income currently (but not less than 5 percent of its

investment assets), and imposes graduated sanctions in the event of a failure to make timely distributions. However, provisions are made to set aside income for later distribution in certain circumstances and to carry forward "excess" distributions. Qualifying distributions include distributions to "public charities" and to private operating foundations, direct expenditures for charitable purposes, and expenditures for assets to be used for charitable purposes.

Income may be set aside for up to 5 years if approved in advance by the Internal Revenue Service, if such an arrangement is needed, as for example, to assure grants for continuing research or as part of a matching grant program. A tax of 15 percent of the undistributed amount is imposed where there has been a failure to distribute by the end of the taxable year after the income was received. If the distributions of the remainders are not made during the "correction period", then a tax of 100 percent is imposed.

*Arguments For.*—(1) These provisions are needed to insure that charity will begin promptly to receive benefits commensurate with the tax benefits available to donors and their foundations. The 5-year set-aside and carryover provisions should provide sufficient flexibility.

(2) The 5-percent minimum payout will reduce the incentive to use foundation assets to control businesses which do not pay substantial dividends.

(3) This provision would discard the "unreasonable accumulation" test contained in the present Internal Revenue Code. Under it, a private foundation can avoid making current distributions for the benefit of charity by investing in assets that produce no current income even though the donor may receive substantial tax benefits from his charitable contribution. Because it is difficult to determine subjectively when an accumulation has become unreasonable, the present law cannot be administered.

(4) Frequently under the present law the only available sanction for an unreasonable accumulation is the loss of exempt status which is ineffective and unduly harsh in many instances. The bill provides more appropriate sanctions designed to assure that current earnings will be distributed to charity.

(5) No private foundation should be permitted to use the tax laws to carve out a perpetual role in society without having to justify its continued existence to the contributing general public.

*Arguments Against.*—(1) The minimum 5-percent payout requirement will force foundations to engage in investment practices that will not permit them to grow commensurate with the rest of the economy.

(2) Foundation managers should be the sole judges of the best timing for the charitable use of foundation income.

(3) A foundation should not be required to distribute earned income currently if it is invested to produce a fair return. There are legitimate purposes for keeping a charitable fund intact for a long period of time, and this provision takes away fiduciary discretion in a major area of fiduciary responsibility.

(4) This provision might force an unwise corporate distribution to satisfy tax requirements and could well discourage many large donors from leaving substantial bequests to private foundations. Also, the necessity for an annual determination of the current fair market value

of foundation assets will breed litigation in areas where the investment asset is close-held and is not susceptible of an easy evaluation.

(5) This problem of accumulation is better attacked by allowing the foundations to control themselves or by placing authority for the administration of such matters in the State, rather than in the Federal Government.

#### 4. Stock Ownership Limitation

*Present law.*—Present law does not deal directly with foundation ownership of business interests, although some cases have held that business involvement can become so great as to result in loss of exempt status.

*Problem.*—The use of foundations to maintain control of businesses appears to be increasing. Whether or not the foundation management is independent of donor control, incentive to control a business enterprise frequently detracts from incentive to produce and use funds for charitable purposes. Temptations are frequently difficult to measure and sanctions presently are applied only in rare cases.

*House solution.*—The bill limits to 20 percent the combined ownership of a corporation's voting stock which may be held by a foundation and all disqualified persons. If someone else can be shown to have control of the business, the 20-percent limit is raised to 35 percent. Existing excess holdings must be disposed of within 10 years (with interim requirements at 2 years and 5 years); excess holdings acquired by gift or bequest in the future generally must be disposed of within 5 years; exceptions are provided in the case of related businesses; and violations are subject to a series of graduated sanctions.

*Arguments For.*—(1) Where private foundations own substantial amounts of stock in corporations, there is a tendency to use the foundation's stockholdings to assert business control and to ignore the production of income by the foundation to be used for charitable purposes. The interests of the foundation's managers are diverted to the maintenance and improvement of the business and away from their charitable duties.

(2) Even where the ownership of a business by a private foundation does not cause the foundation managers to neglect their charitable duties, the corporate business may be run in such a way that it unfairly competes with other businesses whose owners must pay taxes on the income they realize.

(3) The divestiture requirements are sufficiently gradual (especially in the case of existing holdings) so as not to unreasonably disrupt the foundation's investment plans and also the worth of the security being divested. Even as to the future, 5 years should be sufficient where the excess holdings develop after knowledge of the new rules.

(4) Requiring divestiture is better than denying deductions because it permits a donor to give valuable assets to a foundation while allowing the foundation sufficient time to make the assets useful to it.

*Arguments Against.*—(1) This proposal will limit the diversity of foundations, will seriously inhibit their growth, and will prevent the creation of new private foundations.

(2) The fact that a donor derives some intangible benefit because the foundation controls his business does not alter the fact that he has made an irrevocable commitment to charity and as long as the prop-

erty is producing a fair return for charity, there should be no complaint. Any regulation in this area should not be on the foundation's ownership of other businesses, but should be on the use of funds realized from the operation of the other businesses.

(3) The other provisions of the law and the accompanying sanctions should correct the abuses resulting from foundation ownership of other businesses, making this provision unnecessary.

(4) Those whose fortunes consist largely of stock in single enterprises will be reluctant to contribute to private foundations since their only practical method of making a large grant will ultimately require loss of control over the business enterprise. In some cases, other social values may be served by protecting a business from the hazard of loss of control, as where a business has become vital to the economy of a community.

(5) The appropriate time for disposing of an investment asset should be left to the discretion of the foundation's managers and not be directed by the tax laws.

## 5. Limitations on Use of Assets

*Present law.*—A private foundation loses its exemption if its accumulated income is invested in such a manner as to jeopardize the carrying out of charitable purposes. No similar specific limitations apply to investment of assets.

*Problem.*—Under present law a private foundation manager may invest the assets (other than accumulated income) in warrants, commodity futures, and options, or may purchase on margin or otherwise risk the entire corpus of the foundation without being subject to any sanctions. (In one case a court held that a consistent practice of such investments constituted an operation of the foundation for a substantial non-exempt purpose, but the only sanction was loss of tax exemption, which did not really improve the status of charity.)

*House solution.*—The bill imposes upon all the assets of the foundation the same limitations presently applicable only to accumulated income. As a result, under this provision a foundation could not invest its corpus in a manner which would jeopardize the carrying out of its exempt purposes.

*Arguments For.*—(1) The rationale of the existing limitation applies to all the assets of a foundation. It is expected that the 100-percent tax on such jeopardizing investments will provide State officials with the necessary impetus for stronger regulatory supervision over the investment activities of private foundations.

(2) A tax measured by the amount of the improper investment is a better way of dealing with the problem than the present law's choice of either ignoring the impropriety or destroying the foundation's tax-exempt status.

*Arguments Against.*—(1) The restrictions placed on foundation management by these provisions would hamstring honest and competent trustees in dealing with the foundation's portfolio, and would limit investment flexibility.

(2) The abuse this provision seeks to prevent is not sufficiently widespread to require legislative action and in any event, the most effective way to deal with the problem is through substantive laws of the State or municipality.



(3) The jeopardy investment provision of present law has created few difficulties largely because it has rarely been enforced; it creates substantial difficulties of interpretation; and, these difficulties will be much magnified by making the present provision applicable to all the assets of the foundation.

## 6. Other Limitations

*Present law.*—Present law requires that no substantial part of the activities of a private foundation may consist of carrying on propaganda or otherwise attempting to influence legislation. It further provides that no such organization may “participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.” The corresponding charitable contributions deduction provision prohibits substantial propaganda activities but does not deal specifically with the electioneering activities. Another provision prohibits the use of accumulated income to a substantial degree for nonexempt purposes.

*Problem.*—Under the present law’s substantial lobbying provision, a large organization may safely engage in far more lobbying than a small organization. Also, many organizations make their views clear as to which candidates for public office ought to be supported, with confidence that the drastic remedy of loss of exemption will not be imposed. Heavily endowed organizations may engage in lobbying or electioneering and, if exempt status is lost, may continue to avoid tax on investment income by becoming exempt under other provisions of the law. The individual grant device is increasingly being used as a method for funding certain political viewpoints. Organizations that have been called to task for engaging in such activities have claimed that they have no responsibility for how their money is used once a grant has been made.

*House solution.*—The bill provides that private foundations are to be forbidden to spend money for lobbying, electioneering (including voter registration drives), grants to individuals (unless there are assurances that the grants are made on an objective basis), grants to other private foundations (unless the granting foundation accepts certain responsibilities as to the use of the funds by the donee organization), and for any other purpose which is not a charitable purpose. Improper expenditures will be subject to a tax of 100 percent of the amount paid or incurred. Activities will not be classified as prohibited “lobbying” if they consist only of making available the results of non-partisan analysis or research. Also, a private foundation is permitted to appear before a legislative body with regard to matters that might affect the existence of the foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to it.

Voter registration drives will be permitted when conducted on a nonpartisan basis by broadly supported organizations active in at least 5 States, provided that contributions to the organization are not geographically limited as to use.

Grants may be made to individuals chosen in open competition or other nondiscriminatory programmatic basis. Grants may be made in the form of scholarships or fellowships or for a specific purpose. Grants to other private foundations (other than operating foundations) are prohibited unless the granting organization becomes responsible for

how the money is spent and for providing information to the Internal Revenue Service regarding the expenditures.

*Arguments For.*—(1) The present provision regarding the substantiality of improper lobbying, as indicated above, has the peculiar effect of permitting many organizations to engage in significant lobbying activities while others are, for practical purposes, completely forbidden to engage in such activities. This bill separates out the permissible activities from those which are not permissible and imposes the same sort of sanction on the large organization as it does on the small, the same sort of sanction on the heavily endowed organization as it does on the organization that depends upon current contributions.

(2) The bill corrects a defect in the present law through which foundations use their money to finance vacations abroad, trips between jobs for favored beneficiaries, and subsidies for the preparation of materials furthering specific political viewpoints.

(3) The bill accommodates both the interests of flexibility and responsibility, recognizing that the funds involved have already received substantial tax benefits by virtue of their being dedicated to charitable purposes. The foundations granting these funds are the stewards of public trusts and are no longer in the same posture as individuals who may dispose of their own money as they see fit.

*Arguments Against.*—(1) The provisions of the present law are adequate to take care of those isolated situations where private foundations engage in political activity. To impose further restrictions and sanctions would unduly restrict them in legitimate foundation activities.

(2) There is no substantial compelling evidence of abuse in the political activity or grant area relating to private foundations and, in any event, the problem should be met by State—not Federal—regulation.

(3) Private foundations have been increasingly involved in so-called action or social welfare programs. Prohibition of such activities at this time is viewed as an attack upon the causes, or as a punishment of the foundations.

(4) If private foundations are not permitted to “sell” the public as to their views on major social problems, then government will not be moved to act on those problems.

## **7. Disclosure and Publicity Requirements**

*Present law.*—Private foundations must file annual information returns describing gross income, expenses, disbursements for exempt purposes, accumulations, balance sheet, and total amounts of contributions and gifts received. No specific sanctions are provided for failure to file a return except for certain criminal provisions applicable in extreme cases. Information required to be furnished on the information returns is open to the public.

*Problem.*—Existing law is not sufficient in most cases to provide the Internal Revenue Service with the information necessary to determine if the organization continues to be exempt and if it is liable for tax under the new rules for private foundations and the unrelated income and other provisions of this bill.

*House solution.*—The bill requires that information returns be filed annually by additional exempt organizations, that additional information as to donors and highly paid employees be included in the returns,

that sanctions of \$10 per day be imposed for failure to file on time, and that certain information regarding violations must be furnished to appropriate State officials. In addition, the Service must make available, under regulations, information relevant to any determination under State law.

*Arguments For.*—(1) While the present law requires certain exempt organizations to file information returns and unrelated business income tax returns, the experience of the past two decades has indicated that these returns are inadequate to obtain information that is needed. This bill would require information on a more current basis, from more organizations, and would make the information available to more people, especially State officials, and to Congress for use in determining the need for further legislation.

(2) By requiring the names and addresses of all substantial contributors, directors, trustees, other management officials and highly compensated employees, this bill facilitates enforcement of the limitations imposed on self-dealing with "disqualified persons".

(3) The sanction of \$10 per day should be more effective than the present vague possibility of criminal proceedings in the event of failure to file information returns.

*Arguments Against.*—(1) These provisions will compel private foundations to spend money on bookkeeping and accounting services that would otherwise be used for charitable purposes. This is especially undesirable in small foundations which do not have available large amounts of money and which rely on the ability of a few donors who may or may not have the ability to keep books and file detailed returns.

(2) The sanctions for failing to file a return are still too severe, especially since they are imposed on the foundation without any requirement that the Secretary notify the foundation before the sanction becomes operative.

(3) Privacy is unnecessarily invaded by the requirements of filing information regarding substantial contributors and payments to foundation officials. Payments of compensation to such officials are already sufficiently accounted for by the requirement to file withholding statements.

## 8. Change of Status

*Present law.*—Under present law, an organization is exempt if it meets the requirements of the Code, whether or not it has an "exemption certificate". Violation of the exemption provisions results in loss of exempt status, either prospectively or back to the time the violations first occurred.

*Problem.*—Many organizations do not make their existence known and thus receive tax benefits, both for themselves and their donors, without the Internal Revenue Service even being aware of their existence. In many cases, under existing law, loss of exempt status would be only a light burden. This is especially true where the foundation has already received the charitable contributions necessary to endow it and where it could retain its exemption as to its current income by qualifying for exemption under another provision of section 501(c).

*House solution.*—The bill requires new exempt organizations to notify the Internal Revenue Service if they claim to be exempt under section 501(c)(3). Existing and new organizations must notify the

Service if they claim to be other than private foundations. Exceptions may be provided by the Treasury Department to the extent appropriate without interfering with proper administration of the law.

If a private foundation seeks to change its status, or if the Internal Revenue Service determines that it has committed repeated willful violations (or a willful and flagrant violation) of the limitations imposed upon private foundations, then the organization must repay to the Government the aggregate income, estate, and gift tax benefits (with interest) that have flowed to the foundation and all its substantial donors since 1913 from the foundation's exempt status. However, this tax may be abated if the organization distributes all its assets to public charities or acts as a public charity itself for at least 5 years. The substantial contributors whose tax benefits must be taken into account are those who have contributed at least \$5,000 to the private foundation in any one year or contributed more than anyone else to the foundation in any one year, or, in the case of a trust, have created the trust.

*Arguments For.*—(1) The Government ought to know what organizations receive tax benefits.

(2) A charity should not be permitted to deliberately cause loss of its exempt status in order to relieve itself of the law's limitations upon its activities, after it has already obtained substantial tax benefits.

(3) Required repayment of tax benefits (with interest) should make it highly unlikely that any organization which receives the benefits of such exempt status would take lightly its obligations to serve charitable purposes.

(4) The bill should greatly strengthen the position of State officials that seek to regulate the activities of private foundations, and, where necessary, conserve their assets and structures by causing the courts to replace the trustees or foundation managers who threaten to bring such a tax liability upon the foundation.

(5) The provision is needed to close a loophole through which existing private foundations already endowed with tax deductible contributions could change their character, secure tax-exempt status under another provision of the law, and yet escape the restrictive rules applied by the bill to private foundations.

(6) The bill properly requires organizations seeking to avoid the private foundation rules to clearly establish that they are not private foundations.

*Arguments Against.*—(1) It is harsh and unrealistic to require a foundation to repay tax benefits realized by contributors with respect to amounts they contributed to the foundation; determination of the amount of the tax benefit is an impossible task to impose on the foundation.

(2) It is impractical to require that all new exempt organizations must notify the Internal Revenue Service that they are claiming section 501(c)(3) exempt status. Such a requirement cannot be enforced with respect to such exempt organizations as Boy Scout troops, local Parent-Teacher Associations, and similar organizations.

(3) Views as to what constitutes proper forms of charity change with time. Those who have been entrusted with the task of directing a

foundation's activities should be given the flexibility to determine where the best advantages lie in the Internal Revenue Code as to carrying out of their entrusted functions.

(4) The sanction presented by the bill is so great that it would be unlikely that any court would be willing to enforce it.

## 9. Changes in Definitions

*Present law.*—"Private foundation", a term not found in present law, is often used to describe an organization, contributions to which may be deducted only up to 20 percent of an individual donor's adjusted gross income. Deductions of up to 30 percent of a donor's income may be taken for contributions to (1) churches, (2) schools, (3) hospitals, (4) fund-raisers for schools, (5) States and subdivisions, and (6) publicly supported charities.

*Problem.*—In general, the problems that gave rise to the statutory provisions of the bill discussed above appear to be especially prevalent in the case of organizations presently in the 20-percent group. However, it appears that certain organizations presently in the 20-percent category generally do not give rise to the problems which have led to the restrictions and limitations described above.

*House solution.*—The bill provides that a "private foundation" is any organization described in section 501(c)(3) other than:

(1) organizations, contributions to which may be deducted to the extent of 30 percent of an individual's income;

(2) certain types of broadly publicly supported organizations (including membership organizations);

(3) organizations which are organized and operated exclusively for the benefit of one or more organizations described in (1) or (2), and are controlled by one or more organizations, or operated in connection with one organization described in (1) or (2); and

(4) organizations which are organized and operated exclusively for testing for public safety.

The first and fourth categories are essentially the same as in present law. The second category includes a variety of organizations which receive substantial public support and whose income from endowments generally is quite limited. Among those to which this provision would apply are symphony societies, alumni associations, and the Boy Scouts of America. The remaining category includes religious organizations (other than churches), university presses, and certain organizations created and controlled by, and for, "(c)(3) organizations" which are not private foundations.

*Arguments For.*—(1) The objective definition of the term "private foundation" insures that the purposes of the bill can be carried out.

(2) The fact that organizations described above are not classified as "private foundations" does not to any significant extent present problems, since in general these organizations must justify their continued existence to the public and they usually spend for charitable purposes at least as much as their income (in many cases as much as their investment income plus contributions combined).

*Arguments Against.*—(1) Any arithmetic test necessarily means that two organizations, virtually identical in all respects, can receive

sharply different tax treatment because one just barely meets the test and escapes the private foundation rules, while the other just misses the test and falls subject to all of them. The bill would be quite arbitrary in its application.

(2) Limitations ought to be imposed upon all exempt organizations or upon none. To do otherwise, from this viewpoint, results in a discrimination which must not be allowed in the tax laws.

### 10. Private Operating Foundation Definition

*Present law.*—"Operating foundation", a term not found in present law, is sometimes used to describe the type of organization, contributions to which qualify for the unlimited charitable contribution deduction under present law but nevertheless do not qualify under the 30-percent deduction provision. (See Tax Treatment of Charitable Contributions, below.) In order to qualify for such treatment under present law, substantially more than half the organization's assets and substantially all its income must be used or expended directly for its exempt purposes or functions.

*Problem.*—Certain types of organizations which are included in the category of private foundations largely depend for their source of funds upon contributions from other private foundations. Although such organizations perform useful work, nevertheless, many of the problems giving rise to the limitations described above appear to be present in the case of these organizations.

*House solution.*—The bill provides that an "operating foundation," eligible to receive qualifying distributions from other private foundations (but otherwise subject to the limitations imposed upon private foundations) is an organization substantially all of the income of which is expended directly for the active conduct of its exempt purposes or functions, provided that either (1) substantially more than half its assets are devoted to such activities or to functionally related businesses or (2) substantially all its support (other than from endowments) is normally received from at least 5 independent exempt organizations and from the general public (but no more than 25 percent of its support may be received from any one such exempt organization).

These two categories of organizations relate generally to (1) museums and similar organizations and (2) special-purpose foundations, such as learned societies, associations of libraries, and organizations which have developed an expertise in certain substantive areas and which receive grants of funds and direct their research in those specified substantive areas.

*Arguments For.*—(1) Operating foundations make a significant contribution to the framework of American culture. The bill recognizes an operating foundation is carrying out its charitable purpose and properly permits private non-operating foundations to pay over their own income to it.

(2) The provision permitting private foundations to make grants to such institutions may be important to the preservation of major sources of learning.

*Arguments Against.*—(1) The bill is discriminatory because while it

allows a grant to be made to an operating foundation which is supported by at least five independent private foundations, it would not allow a grant to a foundation which received its support from one (or less than five) private foundations. An organization in the latter category which is engaged in worthy, and beneficial programs should also be treated as an operating foundation.

(2) Museums, etc., may range from the world-famous Smithsonian Institution to organizations which are little more than the whim of a wealthy person. Blanket exemptions for such organizations would point to a route for easy avoidance by private foundations generally.

(3) Operating foundations should not be subject to any of the limitations imposed upon private foundations generally. (In rebuttal, it is noted that this might provide too great an incentive for private foundations to avoid the limitations by creating operating foundations which they control.) It is contended by others that operating foundations ought to be subject to the same rules as private foundations.

## 11. Hospitals

*Present law.*—Hospitals qualify for exempt status and may receive deductible charitable contributions as “charitable” organizations.

*Problem.*—It has been contended by some agents that hospitals (unlike educational organizations, churches, and others) must provide some significant amount of charitable services on a no cost-or-loss basis in order to be exempt as “charitable” organizations.

*House solution.*—The bill provides that hospitals are to have the same status as churches and educational institutions for purposes of tax exemption, charitable contributions, and a variety of other matters. The other requirements for exemption—no inurement of profits to private individuals, operation and organization exclusively for exempt purposes, no substantial legislative activities, and no political electioneering activities—continue to apply to hospitals.

*Arguments For.*—(1) These provisions are necessary to eliminate challenges to the tax-exempt status of hospitals on the ground that the hospitals are accepting insufficient numbers of patients at no charge or at rates that are substantially below cost.

(2) By establishing hospitals as a separate exempt category and removing the indefinite test of to what extent a hospital must serve those who cannot pay, this bill removes the uncertainty surrounding the hospital's continued ability to draw necessary support from the public or from private foundations to accomplish its function.

(3) Hospitals perform a useful function of the sort that deserves treatment in section 501 (c) (3) on the same basis as the other organizations specifically named in that provision.

(4) The present environment of governmental assistance to permit medical care to be made available to those otherwise unable to pay, appears to make obsolete the need for hospitals themselves to subsidize the providing of medical care to poor people. This is as true regarding hospitals as it is regarding schools and churches.

*Arguments Against.*—(1) In order to be tax exempt, hospitals historically have been required to render service to the poor whether or not there was an ability to pay for the services rendered. These provisions would do away with that requirement and many marginal income families that are now ineligible for payment of hospital care under Medicaid, and who do not have sufficient resources to pay for hospital treatment might be denied care now available to them. This is especially true in States that do not pay for hospital care of people who are eligible for general assistance under the welfare programs of the State. The bill will pose particular hardships on poor families priced out of hospital care by continually rising health costs and this will put greater pressure on Congress to expand the Medicaid program at the very time Congress is seeking to contract and moderate it.

(2) To the extent hospitals contend Medicare and Medicaid does not pay their full costs they would also contend that they are providing *charitable* services for those patients. If the bill were not changed these hospitals could refuse Medicare or Medicaid patients with impunity or could limit their services to such patients unless the Government met the hospitals' unilateral cost demands. Without the balancing effect of the present Internal Revenue Service position, government might be faced with the choice of either complying with such payment ultimatums or seeing millions of poor and aged citizens denied necessary care in community nonprofit hospitals.

(3) There is no substantial evidence that contributors to hospitals will decrease or stop their donations because the Internal Revenue Service is questioning the tax-exempt status of a hospital (or hospitals) on the ground that sufficient charitable services are not being rendered to the poor.

(4) The extent of free and "below cost" hospital care has diminished greatly with the advent of public programs such as Medicare and Medicaid. The pressure to provide free care has lessened to the extent that these multi-billion dollar programs and private hospital insurance are now paying for many of those whose bills previously went unpaid.

(5) The bill discards the charitable basis—the "community service to all" concept—on which tax exemption of hospitals is founded.

(6) If there is a legitimate complaint that Internal Revenue rulings are too vague on this point, a clarifying amendment establishing statutory standards is the appropriate remedy rather than the blanket approach of the House provision.

(7) Since the need for new legislative language has arisen because of uncertainties in administration, then the resolution of such uncertainties could be handled on an administrative basis.

## 12. Effective Dates

The provisions described above apply to taxable years beginning after December 31, 1969, except that additional time is permitted in the case of existing organizations to reform their governing instruments to conform to the new law as to business holdings and distributions of income. Also the 5-percent minimum distribution requirement will not apply, in the case of existing organizations, until taxable years beginning after December 31, 1971. However, any organization



that was a private foundation (under the rules of this bill) for its last taxable year ending before May 27, 1969, will be subject to the bill's requirements until it terminates its status as described previously in Change of Status.

## B. OTHER TAX-EXEMPT ORGANIZATIONS

### 1. The "Clay Brown" Provision or Debt-Financed Property

*Present law.*—Under present law, charities and some of the other types of exempt organizations are subject to tax on rental income from real property to the extent the property was acquired with borrowed money. However, this provision does not apply to all tax-exempt organizations and there is an important exception which includes rental income from a lease of 5 years or less. Nor does the tax apply to income from the leasing by a tax-exempt organization of assets constituting a going business.

*Problem.*—During the past several years weaknesses in the present provision relating to debt-financed property have been exploited in several different respects. As a result a large number of tax-exempt organizations have used their tax-exempt privileges to buy businesses and investments on credit, frequently at what is more than the market price, while contributing little or nothing themselves to the transaction other than their tax exemption.

In a typical *Clay Brown* situation a corporate business is sold to a charitable or educational foundation, which makes a small or no down payment and agrees to pay the balance of the purchase price out of profits from the property. The charitable or educational foundation liquidates the corporation, leases the business assets back to the seller, who forms a new corporation to operate the business. The newly formed corporation pays a large portion of its business profits as "rent" to the foundation, which then pays most of these receipts back to the original owner as installment payments on the initial purchase price.

In this manner in the *Clay Brown* case (1965 Supreme Court case), a business was able to realize increased after-tax income, and the exempt organization acquired the ownership of a business valued at \$1.3 million without the investment of its own funds. In the recent (1969) *University Hill Foundation* case, the Tax Court upheld the acquisition of 24 businesses by the University Hill Foundation in the period 1945 to 1954. Other variants of the debt-financed property problem have also been used.

*House solution.*—The House bill amends the code to provide that all exempt organizations' income from "debt-financed" property is to be subject to tax in the proportion the property is financed by debt. Thus, for example, if a business or investment property is acquired subject to an 80 percent mortgage, 80 percent of the income and 80 percent of the deductions are taken into account for tax purposes. As the mortgage is paid off, the percentage taken into account diminishes. Capital gain on the sale of debt-financed property is also taxed. The amendment makes exceptions for property to be used for an exempt purpose within a reasonable time, and also for property acquired by gift or inheritance under certain conditions. Also there is a special exception for the sale of annuities, and for debts insured by the

Federal Housing Administration to finance low and moderate income housing. For years before 1972, only indebtedness incurred on or after June 28, 1966, will be taken into account.

*Arguments For.*—(1) This provision would cure the defect in the present law which allows an exempt organization to acquire a going business for an inflated price, without the investment of its own funds, and pay the owners from the untaxed earnings of the business.

(2) The bill creates fair competition between tax-free and taxpaying organizations seeking to purchase a going business.

(3) The bill discourages an owner of a going business from seeking to sell it to a tax-free organization in an arrangement by which he in effect, converts his ordinary income from the operation of that business into a tax-favored capital gain.

(4) Tax-exempt organizations should be taxed on their debt-financed income because in such cases they are, in effect, using their tax-exempt status to “earn” income for them. It is suggested that the exemption was intended simply to remove from tax income on contributions from the general public, not as a tool for generating income without public contribution. In this regard, both the United States Catholic Conference and the National Council of Churches have expressed approval both of the objectives and the approach of the House bill.

*Arguments Against.*—(1) Other provisions of the bill extend the unrelated business income tax to organizations which previously were tax-exempt on income from a going business. Thus, they can no longer purchase a business with tax-free earnings, and this provision of the bill is now unnecessary.

(2) Rather than devise special rules for business purchased by tax-exempt organizations, the general rules of the bill governing debt-financed acquisitions could be applied.

(3) The House provisions go too far in that they apply to debt-financed cases whether or not the property is leased back to the sellers.

(4) This is an infringement on the tax-exempt status generally available for charitable organizations with respect to investment income

## **2. Extension of Unrelated Business Income Tax to All Exempt Organizations**

*Present law.*—Under present law the tax on unrelated business income applies only to certain tax-exempt organizations. These include:

(a) Charitable, educational, and religious organizations (other than churches or conventions of churches);

(b) Labor and agricultural organizations;

(c) Chambers of commerce, business leagues, real estate boards, and similar organizations;

(d) Mutual organizations which insure deposits in building and loan associations and mutual savings banks; and

(e) Employees' profit sharing trusts and trusts formed to pay (non-discriminatory) supplemental unemployment compensation.

*Problem.*—In recent years, many of the exempt organizations not now subject to the unrelated business income tax—such as churches, social clubs, fraternal beneficiary societies, etc.—have begun to engage

in substantial commercial activity. Some churches, for example, are engaged in operating publishing houses, hotels, factories, radio and TV stations, parking lots, newspapers, bakeries, restaurants, etc. Furthermore, it is difficult to justify taxing a university or hospital which runs a public restaurant or hotel or other business and not tax a country club or lodge engaged in similar activity.

*House solution.*—The House bill extends the unrelated business income tax to all exempt organizations (except United States instrumentalities created and made tax exempt by a specific act of Congress). The organizations which will newly be made subject to this tax include churches and conventions or associations of churches, social welfare organizations, social clubs, fraternal beneficiary societies, employees' beneficiary organizations, teachers retirement fund associations, benevolent life insurance associations, cemetery companies, credit unions, mutual insurance companies, and farmers cooperatives formed to finance crop operations.

As under present law, in general this tax does not apply unless the business is "regularly carried on" and therefore does not apply, for example, in cases where income is derived from an annual athletic exhibition. (See discussion under Investment Income, below.) Under the amendments made by the bill, in the case of any membership organization, any income resulting from charges to the members for goods, facilities, and services supplied in carrying out the exempt function is not subject to tax.

The bill contains several administrative provisions including one providing that no audit of a church is to be made unless the principal internal revenue officer for the region believes that the church may be engaged in a taxable activity. Churches will not be subject to tax for six years on businesses they now own.

*Arguments For.*—(1) The bill eliminates unfair competition of tax-free organizations engaged in the same business as taxpaying organizations.

(2) The bill corrects an injustice by which some tax-exempt organizations are subjected to tax on their business income while others remain tax-free with respect to the same sort of business income.

(3) Unless the unrelated business income of all exempt organizations is taxed, the Federal revenues will suffer as more and more business moves from taxable to tax-exempt entities.

(4) Both the United States Catholic Conference and the National Council of Churches have indicated approval of the taxation of the unrelated business income of churches.

(5) The bill raises questions as to what activities will be related or unrelated in imposing this tax, whether intermittent activities such as football games held to raise funds for charitable purposes and activities primarily carried on for the benefit of members of the organizations are subject to tax. For the most part, these problems should be resolved on the basis of the present rulings and regulations although, because of the new types of organizations being brought under the tax, the regulations probably will require expansion to cover new types of situations.

*Arguments Against.*—(1) The provisions tax unrelated business income, even though there is no competition with a taxpaying entity.

(2) In taxing the investment income of organizations not heretofore subject to the unrelated income tax, such as a social club, little additional revenue would be provided but many of these clubs would be destroyed.

### 3. Taxation of Investment Income of Social, Fraternal, and Similar Organizations

*Present law.*—Under present law the investment income of social clubs, fraternal beneficiary societies, and employees' beneficiary associations are exempt from income tax.

*Problem.*—Since the tax exemption for social clubs, fraternal beneficiary societies, and employees' beneficiary associations is designed, at least in part, to allow individuals to join together to provide recreational or social facilities without tax consequences, the tax exemption operates properly only where the sources of income of the organization are limited to receipts from the membership. Where an organization receives income from sources outside the membership, such as income from investments, upon which no tax is paid, the membership receives a benefit from the tax-exempt funds used to provide pleasure or recreational facilities.

*House solution.*—The House bill provides for the taxation (at regular corporate rates) of the investment income and other unrelated income of social clubs, fraternal beneficiary associations, and employees' beneficiary associations. This will not apply, however, to such income of fraternal beneficiary associations and employees' beneficiary associations to the extent it is set aside to be used only for the exempt insurance function of these organizations and for charitable purposes. If in any year an amount is taken out of the set-aside and used for any other purpose, the amount taken out will be subject to tax in such year.

*Arguments For.*—(1) This provision is needed to close the loophole where certain exempt organizations which are comprised of individuals who join together for mutual benefit (such as a social club) receive untaxed income from investments and funnel the benefit to their members in the form of an increase in services or a reduction in the cost of services or membership fees.

(2) Continuing tax-exempt status for investment income in these situations distorts the original purpose of Congress in enacting the present law and it should be corrected.

*Arguments Against.*—(1) It is harsh and discriminatory to tax as unrelated business income the investment income of these specific organizations while similar income received by other exempt organizations is not taxed.

(2) It is incorrect to assume that the benefit of the investment income in these organizations inures to the personal benefit of the members. In many cases the income is used for charitable or for other socially desirable purposes, and these efforts should not be thwarted.

(3) Congress traditionally has exempted from tax for so-called tax-exempt organizations any investment income received. To tax the investment income of these organizations represents an infringement of that traditional exemption.

#### 4. Interest, Rent, and Royalties From Controlled Corporations

*Present law.*—Under present law, rent, interest, and royalty expenses are deductible in computing the income of a business. On the other hand, receipt of such income by tax-exempt organizations generally is not subject to tax.

*Problem.*—Some exempt organizations “rent” their physical plant to a wholly owned taxable corporation for 80 percent or 90 percent of all the net profits (before taxes and before the rent deduction). This arrangement enables the taxable corporation to escape nearly all of its income taxes because of the large “rent” deduction. While courts have occasionally disallowed some, or all, of the rent deduction, the issue is a difficult one for the Internal Revenue Service.

*House solution.*—The code would be amended to provide that in any case in which an exempt organization owns more than 80 percent of a taxable subsidiary, interest, annuities, royalties and rents are to be treated as “unrelated business income” and subject to tax. The deductions connected with production of such income are allowed.

*Arguments For.*—(1) This provision eliminates the “gimmick” whereby a subsidiary corporation is set up by an exempt organization to operate a business which earns income and pays interest, rents and royalties to the exempt organization in amounts sufficient to wipe out any tax liability of the subsidiary corporation.

(2) Since the interest, rents and royalties are derived from the operation of an active business it would be wrong to allow the exempt organization to treat it as passive income, thwarting the intent of the Congress in enacting the unrelated business income tax.

*Arguments Against.*—(1) The bill is too broad and would tax as unrelated income all interest, rents, and royalties received by a tax-exempt organization from a controlled corporation without regard to the purpose or propriety of such payments.

(2) The bill would tax monies that would otherwise be used for charitable purposes.

(3) To tax rental, interest, or royalty income in such cases could result in a tax on investment income even though the payments to the tax-exempt organization were small relative to the value of the facilities or other property rented, borrowed, or subject to a royalty payment.

#### 5. Limitation on Deductions of Nonexempt Membership Organizations

*Present law.*—Some courts have held that taxable membership organizations cannot create a “loss” by supplying their members services at less than cost. Other courts have held instead that such a “loss” is permissible, that the expenses of providing such services at less than cost will offset from taxation additional income earned by the organization from investments or other activities.

*Problem.*—In some cases membership organizations, which also have business or investment income, serve their members at less than cost and offset this book loss against their business or investment income and as a result pay no income tax. In an important decision the courts held that a non-exempt water company was not subject to tax

when the "losses" in supplying its members water offset its investment income. Other courts have held to the contrary.

*House solution.*—The House bill provides that in the case of a taxable membership organization the deduction for expenses incurred in supplying services, facilities or goods to members is allowed only to the extent of the income from such members. Thus, no membership organization will be permitted to escape tax on business or investment income by using this income to serve its members at less than cost and deducting the book "loss."

*Arguments For.*—(1) To permit a membership organization to offset investment or business income against a loss arising from services provided to members is the same as if an individual were allowed to offset his personal or recreational expenses against his investment income.

(2) This provision is necessary to prevent exempt membership organizations from attempting to avoid the effect of the unrelated business income rule by giving up their exempt status and deducting the cost of providing services for members from its investment or nonmembership income.

*Argument Against.*—(1) There is nothing reprehensible about a non-exempt membership organization offsetting the expense of providing services to members against investment income or income derived from services to nonmembers. The Courts have upheld this approach.

(2) To deny an offset of membership losses and investment income is to tax a membership organization on income when it has no profit.

## 6. Income From Advertising

*Present law.*—Late in 1967 the Treasury promulgated regulations under which the income from advertising was treated as "unrelated business income" even though such advertising appeared, for example, in a periodical related to the educational or other exempt purpose of the organization.

*Problem.*—While the House concluded that the regulations reached an appropriate result in specifying that in carrying on an advertising business in competition with other taxpaying advertising businesses, a tax should be paid, nevertheless, the statutory language on which the regulations were based was sufficiently unclear so that substantial litigation could have resulted from these regulations. To overcome this problem the regulations were placed in the tax law.

*House solution.*—The House bill provides that income from advertising (or a similar activity) is included in unrelated business income even though the advertising is carried on in connection with activities related to the exempt purpose.

*Arguments For.*—(1) Advertising in a journal published by an exempt organization competes with tax-paying organizations that sell advertising, and this bill properly taxes the advertising income of the exempt organization.

(2) Activity such as advertising should not lose its identity as a trade or business because it is carried on within a larger scope of similar activities which may be related to the exempt purpose of the organization.

*Arguments Against.*—(1) Advertising in trade journals does not normally compete to any great extent with tax-paying corporations, publishing commercial magazines because it is usually of a technical nature, and attracts the attention only of those people interested in the professional aspects of the publication.

(2) This bill ignores the fact that it is difficult to separate technical comment (such as where technical benefits of a pharmaceutical product is described in an advertisement in a medical journal) from pure advertising.

(3) Many trade organizations depend on advertising income heavily, and the taxing of that income will seriously hamper their exempt endeavors.

## C. CHARITABLE CONTRIBUTIONS

### 1. 50 Percent Charitable Limitation Deduction

*Present law.*—Under present law, the charitable contributions deductions allowed individuals generally is limited to 30 percent of a taxpayer's adjusted gross income. In the case of gifts to certain private foundations, however, the deduction is limited to 20 percent of a taxpayer's adjusted gross income. (In addition, in limited circumstances, a taxpayer is allowed an unlimited charitable contributions deduction.)

*Problem.*—It has been suggested that it would be desirable to strengthen the incentive for charitable giving by increasing the present 30 percent limitation on the charitable contribution to 50 percent of a taxpayer's income. Moreover, it was hoped that this increase would offset any decreased incentive resulting from the repeal of the unlimited charitable contributions deduction (see page 32). In addition, the combination of these two actions means that charity (on a tax-free basis) can remain an equal partner with respect to an individual's income but cannot reduce an individual's tax base by more than one-half.

*House solution.*—The House bill increases the general 30 percent limitation on an individual's charitable contribution deduction to 50 percent. The 20 percent charitable contribution deduction limitation in the case of gifts to private foundations is not increased by the bill. Also, contributions of appreciated property would continue to be subject to the present 30 percent limitation. These changes apply to taxable years beginning after 1969.

*Arguments For.*—(1) It is more appropriate to have a general limitation of 50 percent with no unlimited charitable contribution deduction so that all taxpayers may be treated equally with respect to charitable giving.

(2) Limiting the additional contribution deduction to cases where no appreciation is involved will prevent any further increase in advantages arising from the omission of income given to charity from an individual's tax base.

*Arguments Against.*—(1) This provision benefits a particular class of taxpayers who already are able to take advantage of tax privileges that are not available to lower income taxpayers.

(2) The justification for increasing the limit was to provide a greater incentive to offset the disincentive resulting from a series of

restrictive charitable contribution suggestions which were rejected by the House. Since the bill does not contain these restrictions this "compensation" is unwarranted.

(3) From the standpoint of the educational institutions and public charities the increase to 50 percent in terms of total contributions they receive will not result in the very large contributions they could solicit under the unlimited charitable contribution deduction.

(4) Failing to make the additional contribution deduction available in the case of property which has appreciated in value will minimize the value of this additional deduction.

## 2. Repeal of the Unlimited Deduction

*Present law.*—The charitable contributions deduction for individuals generally is limited to 30 percent of the taxpayer's adjusted gross income. An exception to the 30 percent general limitation allows a taxpayer an unlimited charitable contributions deduction, if in 8 out of the 10 preceding taxable years the total of the taxpayer's charitable contributions plus income taxes paid exceeded 90 percent of his taxable income.

*Problem.*—It has been pointed out that the unlimited charitable contributions deduction has permitted a number of high-income persons to pay little or no tax on their income. It appears that the charitable contributions deduction is one of the two most important itemized deductions used by high-income persons, who pay little or no income tax, to reduce their tax liability.

*House solution.*—The unlimited charitable contributions deduction is to be eliminated for years beginning after 1974. During the interim period, an increasing limitation is to be placed on the amount by which the deduction can reduce the individual's taxable income. For taxable years beginning in 1970, the unlimited deduction is not to be allowed to reduce a person's taxable income in this manner to less than 20 percent of his adjusted gross income. This percentage is to be increased by 6 percentage points a year for the years 1971 through 1974. The bill also provides that the percentage of the taxpayer's income which must be given to charity or paid in income taxes each year in order to qualify for the unlimited deduction during this interim period is to be reduced to 80 percent in 1970, and is then to be reduced by 6 percentage points a year for the years 1971 through 1974.

*Arguments For.*—(1) It is not equitable to allow certain high-income persons to pay little or no income tax by means of the unlimited charitable contributions deduction, while most taxpayers are presently limited to a maximum charitable deduction of 30 percent of income each year (with a 5-year carryover of contributions in excess of 30 percent). Further, the qualification requirement for an unlimited deduction is related not to total economic income but only to "taxable" income, and some taxpayers have sufficient tax-free income and/or other deductions so that they may qualify and yet not actually have given up most of their economic income.

(2) Charitable contributions should not be allowed to reduce an individual's tax base by more than one-half. Thus, the repeal of the unlimited charitable deduction, combined with an increase in the general limitation from 30 percent of adjusted gross income to 50 percent



means that charity can remain an equal partner (but no more) with respect to an individual's income.

(3) This provision closes a "loophole" that has allowed a small number of high-income persons to pay little or no tax on their incomes which sometimes exceed \$1 million a year.

(4) Because of the possibility of contributing highly appreciated property to charity for which the unlimited charitable contribution deduction is claimed, a high income taxpayer can contribute an amount sufficient to offset his income and place himself in a more favorable after-tax situation than if he had not made the charitable contribution; thus, the tax shelter is of greater benefit to the donor than the contribution is to charity. It is this tax-planning which motivates the gift—and not a desire to benefit charity.

*Arguments Against.*—(1) The relatively small gain in tax revenue (\$25 million a year) would result in a large direct loss to philanthropic endeavors.

(2) The bill fails to recognize that persons who make a significant long-run commitment of a very large part of their income make a contribution to charitable activities that would be difficult to replace.

### **3. Charitable Contributions of Appreciated Property**

*Present law.*—A taxpayer who contributes property which has appreciated in value to charity generally is allowed a charitable contributions deduction for the fair market value of the property at the time of contribution. Further, no income tax is imposed on the appreciation in value of the property at the time of the gift. In addition, if property is sold to a charity at a price below its fair market value—a so-called bargain sale—the proceeds of the sale are considered to be a return of the cost and are not required to be allocated between the cost basis of the "sale" part of the transaction and the "gift" part of the transaction. The seller is allowed a charitable contributions deduction for the difference between the fair market value of the property and the selling price (often at his cost or other basis).

*Problem.*—The combined effect of not taxing the appreciation in value and at the same time allowing a charitable contributions deduction for the fair market value of the property given is to produce tax benefits significantly greater than those available with respect to cash contributions. The tax saving which results from not taxing the appreciation in the case of gifts of long-term capital assets is the capital gains tax which would have been paid if the asset were sold. In the case of ordinary income type assets, however, this tax saving is at the taxpayer's top marginal tax rate. In either case, the tax saving from not taxing the appreciation in value is combined with the tax saving of the charitable deduction at the taxpayer's top marginal rate. As a result, in some cases it is possible for a taxpayer to realize a greater after-tax profit by making a gift of appreciated property than by selling the property, paying the tax on the gain, and keeping the proceeds.

In addition, in the case of a so-called bargain sale to a charity (often at the taxpayer's cost or other basis), the taxpayer is allowed a charitable deduction for the appreciation in excess of the sales price and no

tax is paid on this appreciation. In cases where the sales price is equal to the cost basis, the entire appreciation is deductible and escapes taxation.

*House solution.*—The bill in the case of certain charitable contributions of appreciated property takes this appreciation into account for tax purposes. This is true of gifts to a private foundation, other than a private operating foundation or one which within 1 year distributes an equivalent amount to, or for the use of, “public” charitable organizations or private operating foundations. Also, under the bill, appreciation in value is taken into account in the case of gifts of tangible personal property (such as paintings, art objects, and books), a future interest in property, and property which would give rise to ordinary income if sold. Where the appreciation is taken into account, the taxpayer has the option of reducing his deduction to the amount of his cost or other basis for the property, or taking a charitable deduction for the fair market value of the property but at the same time including the appreciation in value of the property in his income. These provisions relate to gifts of appreciated property made after 1969.

In the case of so-called bargain sales to charities—where a taxpayer sells property to a charitable organization for less than its fair market value (often at its cost basis)—the bill provides that the cost or other basis of the property is to be allocated between the portion of the property “sold” and the portion of the property “given” to the charity on the basis of the fair market value of each portion. This provision applies to sales made after May 26, 1969.

*Arguments For.*—(1) The charitable contributions deduction was not intended to provide greater—or even nearly as great—tax benefits in the case of gifts of property than would be realized if the property were sold. In gifts of appreciated property where the tax saving is so large, little, if any, charitable motivation may remain. In such cases, the Federal Government is almost the sole contributor to the charity.

(2) Concerning the specific types of appreciated property where the House bill requires appreciation to be taken into account for tax purposes, it is maintained that these types of property either result in the maximum tax benefit where the taxpayer is likely to be better off by making the contribution than by retaining the property (i.e., ordinary income property) or are very difficult to value and often result in overvalued claims for deductions (i.e., tangible personal property and future interests in property).

(3) With regard to gifts of appreciated property to private non-operating foundations, it is thought that there is a high possibility that the property itself (or its equivalent value) will not actually be used for charitable purposes until some distant time in the future. This latter limitation may have the effect of increasing gifts of appreciated property to “public” charities, since those who are primarily interested in the tax benefits presumably would make their gifts of appreciated property to such charities.

(4) This provision partially closes the loophole whereby high-bracket taxpayers are able to realize a greater after-tax profit by making a gift of appreciated property to charity than they are by selling it, paying the tax on the gain, and keeping the proceeds.

(5) Because the donor received the beneficial enjoyment of giving his property to charity, it is appropriate to tax the appreciation in value of the property to him.

(7) The present system of allowing a contribution deduction for the fair market value of property without requiring that the appreciation be included in the donor's income has led to many abuses of the charitable contribution deduction involving gifts of paintings, statuary and similar art objects at artificially inflated prices calculated to produce the maximum tax benefit for the donor. The bill corrects this practice.

*Arguments Against.*—(1) This type of giving represents a major source of income to private educational institutions and colleges, and if it were eliminated Federal funds would be needed to support these colleges, raising constitutional questions regarding the use of Federal funds because of the traditional separation of Church and State.

(2) The result is much too complex and discriminatory in that gifts of the same type of property may receive different tax treatment, depending on the type of recipient.

(3) It does not appear to be appropriate to differentiate between types of property given to the same charitable organization—properties which may have identical fair market values in the hands of the taxpayer.

(4) Requiring the appreciation in value to be included in the tax base if the fair market value is claimed as a deduction for certain charitable gifts is a significant departure from the accepted practice of not taxing unrealized appreciation as "income."

#### 4. Two-Year Charitable Trust

*Present law.*—Under present law, an individual may establish a trust for two years or more with the income from property placed in the trust being payable to charity. In such a case although the trust instrument provides that after the designated period of time the property is to be returned to him, the income from the trust property is not taxed to the individual. However, the individual does not receive a charitable contributions deduction in such a case.

*Problem.*—The special two-year charitable trust rule has the effect of permitting charitable contributions deductions in excess of the generally applicable percentage limitations on such deductions. For example with the 50 percent limitation on such deductions contained in the House bill, the maximum deductible contribution that could generally be made each year by an individual who had \$100,000 of dividend income (but no other income) would be \$50,000. However, if the individual transferred 60 percent of his stock to a trust with directions to pay the annual income (\$60,000) to charity for two years and then return the property to him, the taxpayer would exclude the \$60,000 from his own income each year. In effect, then, the individual has received a charitable contributions deduction equal to 60 percent of his income.

*House solution.*—The House bill eliminates the rule under which an individual is not taxed on the income from property which he transfers to a trust to pay the income to charity for a period of at least two years. This provision applies to transfers after April 22, 1969.

*Argument For.*—(1) This provision would prevent the avoidance of the limitations on the charitable contribution deduction through the device of a two-year charitable trust. In effect, the two-year trust rule is nothing more than a subterfuge for assigning income.

*Arguments Against.*—(1) There is little abuse connected with the two-year charitable trust rule and in many cases it leads to an ultimate gift of the total corpus to a charitable institution.

(2) The import of this provision is contrary to the objective of encouraging philanthropy highlighted by the provision which raises the ceiling on the charitable contribution deduction to 50 percent.

## 5. Charitable Contributions by Estates and Trusts

*Present law.*—Present law allows a nonexempt trust (or estate) a full deduction for any amount of gross income which it permanently sets aside for charitable purposes. There is no limitation on the amount of this deduction.

*Problem.*—To retain the deduction allowed by present law for non-exempt trusts for amounts set aside for charity (rather than paid to charity) was viewed as inconsistent with other changes made by the House bill in the treatment of charitable trusts.

Nonexempt trusts generally are subject to the same requirements and restrictions imposed on the private foundations since to the extent of the charitable interest their use achieves the same result. The current income distribution requirement generally applicable to foundations is not imposed on these nonexempt trusts, however, but the same result is achieved by denying the set-aside deduction to these trusts for their current income. In other words, to obtain the charitable deduction the nonexempt trusts must pay out their income currently for charity much in the same manner as private foundations are required to do.

In the case of a charitable remainder trust (i.e., a trust which provides that the income is to be paid to a noncharitable beneficiary for a period of time and the remainder interest is to go to charity) the House bill provides that if specified requirements are met, the trust is to be tax exempt. These requirements are designed to limit the allowance of a charitable deduction for the remainder interest upon creation of the trust to situations where there is a reasonable correlation between the amount of the deduction and the benefits that the charity will ultimately receive. Where these requirements are met, and the trust is thus accorded tax-exempt status, there is no need to allow the trust a deduction for amounts set aside for charity. To accord non-exempt trusts (with a remainder interest for charity) consistent treatment, it is necessary to deny them a deduction for amounts set aside for charity.

*House solution.*—The bill eliminates the set-aside deduction presently allowed nonexempt trusts. What were nonexempt trusts which meet the annuity or unitrust rules with respect to their remainder charitable interests are with respect to this interest treated as exempt trusts. This provision applies to amounts set aside after the enactment of the bill.

*Argument For.*—Allowing nonexempt trusts a deduction for amounts set aside for the future use of charity is not consistent with the other limitations placed by the bill on charitable trusts.

*Argument Against.*—The elimination of this deduction will discourage trusts from setting aside amounts for charity.

## 6. Gifts of the Use of Property

*Present law.*—Under existing law a taxpayer may claim a charitable deduction for the fair-rental value of property which he owns and gives to a charity to use for a specified time. In addition, he may exclude from his income the income which he would have received and been required to include in his tax base had the property been rented to other parties.

*Problem.*—By giving a charity the right to use property which he owns for a given period of time a taxpayer achieves a double benefit. For example, if an individual owns an office building, he may donate the use of 10 percent of its rental space to a charity for one year. He then reports for tax purposes only 90 percent of the income which he would otherwise have been required to report if the building were fully rented, and he claims a charitable deduction (equal to 10 percent of the rental value of the building) which offsets his already reduced rental income.

*House solution.*—The House bill provides that the charitable deduction is not to be allowed for contributions to charities of less than a taxpayer's entire interest in property. Therefore, no deduction will be allowed where a contribution is made of the right to use property for a period of time. In such a case, however, a taxpayer will be able to continue to exclude from his income the value of the right to use property so contributed. This provision applies with respect to gifts made after April 22, 1969.

*Argument For.*—It is appropriate to eliminate the double benefit which taxpayers have enjoyed with respect to contributions of the use of their property. This provides greater equity for taxpayers generally, in that many taxpayers do not have property which can be utilized in this manner.

*Arguments Against.*—(1) When an individual donates the use of property to a charitable organization he does not receive a double benefit because while, under the present law, he receives a deduction for the full rental value of the property he is not actually receiving any income from third parties while the property is being used by the charitable organization.

(2) The contribution of the use of property is a valuable gift, giving a charity exclusive control and possession for a period of time, and should be treated in the same manner as an outright gift of property.

## 7. Charitable Remainder Trusts

*Present law.*—Under present law an individual may make an indirect charitable contribution by transferring property to a trust and providing that the trust income is to be paid to private persons for a period of time with the remainder to go to a charity. Generally, a charitable contributions deduction is allowed for the remainder interest given to charity. The amount of the deduction is based on the present value of the remainder interest which is determined by using actuarial life expectancy tables and an assumed interest rate of  $3\frac{1}{2}$  per cent.

*Problem.*—Present rules allow a taxpayer to receive a charitable contribution deduction for a gift to charity of a remainder interest in

trust which is substantially in excess of the amount the charity may ultimately receive. This is because the assumptions used in calculating the value of the remainder interest may bear little relation to the actual investment policies of the trust. For example, the trust assets may be invested in high-income, high-risk assets. This enhances the value of the income interest but decreases the value of the charity's remainder interest. This factor, however, is not taken into account in computing the amount of the charitable contribution deduction.

*House solution.*—The bill limits the availability of a charitable contribution deduction in the case of a charitable gift of a remainder interest in trust to situations where there is a closer correlation between the amount to be received by charity and the amount of the deduction allowed on the creation of the trust. In general, a deduction is to be allowed only where the trust specifies the annual amount which is to be paid to the noncharitable income beneficiary either in dollar terms or as a fixed percentage of the value of the trust's assets (as determined each year).

The amount of the deduction allowed on the creation of the charitable remainder interest in trust, thus, would be computed on the basis of the actual relative interests of the noncharitable income and the charitable remainder beneficiaries in the trust property.

Generally, this provision applies to transfers in trust made after April 22, 1969 (except in the case of the estate tax where it applies with respect to persons dying after the enactment of the bill).

*Arguments For.*—(1) The limitations provided by this provision on the allowance of a charitable contribution deduction for gifts of remainder interests in trust will assure a better correlation between the deduction allowed and the benefit to charity. This is because the limitation will remove the present incentive to favor the non-charitable income beneficiary over the charitable remainder beneficiary by means of manipulating the trust's investments.

(2) The bill properly prevents the taking of a charitable contribution deduction for ostensible gifts of charitable remainder interests in trust where it is not probable that the gift will ultimately be received by the charity (such as where the charitable interest is only a contingent remainder interest) or where the trust permits invasion of the charitable share for the benefit of the non-charitable interest.

*Arguments Against.*—(1) This provision is not necessary because local laws which impose heavy responsibilities upon trustees and fiduciaries serve as sufficient assurance that trusts will be handled properly.

(2) The limitations restrict the flexibility presently available to persons who wish to make gifts to charity in the form of a remainder interest in trust. This smaller degree of flexibility might lead to an undue curtailment of this type of charitable gift.

## 8. Charitable Income Trust With Noncharitable Remainders

*Present law.*—Under present law, a taxpayer who transfers property to a trust to pay the income to a charity for a period of years with the remainder to go to a noncharitable beneficiary, such as a friend or member of his family, is allowed a charitable contributions deduction for the value of the income interest given to charity. In addition, neither he nor the trust is taxed on the income earned by the trust which is given to charity.

*Problem.*—A taxpayer receives a double tax benefit where he is allowed a charitable deduction for the value of an income interest in trust given to charity and also is not taxed on the income earned by the trust.

*House solution.*—The bill generally provides that a charitable contribution deduction is not to be allowed where a person gives an income interest to charity in trust unless he is taxable on the trust income. Moreover, even in this case, the charitable deduction will not be allowed unless the charity's income interest is in the form of a guaranteed annuity or is a fixed percentage (payable annually) of the value of the trust property (as determined each year).

The bill also, in effect, provides for the recapture of the part of the charitable deduction previously received by a taxpayer where he ceases to be taxable on the trust income (i.e., that part of the deduction representing the income on which the taxpayer will not be taxed is recaptured).

The provision applies to transfers of property to trusts after April 22, 1969.

*Arguments For.*—(1) The bill is needed to prevent a taxpayer from taking a charitable contribution deduction for the present value of an income interest in trust, and at the same time failing to pay a tax on the income earned by the trust.

(2) It assures in cases where a deduction is allowed that the amount received by charity will bear a reasonable correlation to the amount of the deduction.

*Arguments Against.*—(1) This provision is not necessary because local laws which impose heavy responsibilities upon trustees and fiduciaries serve as sufficient assurance that the trusts will be handled properly.

(2) Since this provision restricts the charitable contribution deduction in certain cases, it is undesirable because it will therefore decrease contributions to charity.

## D. FARM LOSSES

### 1. Gains From Dispositions of Property Used in Farming Where Farm Losses Offset Nonfarm Income

*Present law.*—Under present law, income losses from farming may be computed under more liberal accounting rules than those generally applicable to other types of businesses. A cash method of accounting under which costs are deducted currently may be used, rather than an accrual method of accounting and inventories under which the deduction of costs would be postponed. In addition, a taxpayer in the business of farming may deduct expenditures for developing business assets (such as raising a breeding herd or developing a fruit orchard) which other taxpayers would have to capitalize. In addition, capital gains treatment quite often is available on the sale of farm assets.

*Problem.*—Although the special farm accounting rules were adopted to relieve farmers of bookkeeping burdens, these rules have been used by some high-income taxpayers who are not primarily engaged in farming to obtain a tax, but not an economic, loss which is then deducted from their high-bracket, nonfarm income. In addition, when these high-income taxpayers sell their farm investment, they often

receive capital gains treatment on the sale. The combination of the current deduction against ordinary income for farm expenses of a capital nature and the capital gains treatment available on the sale of farm assets produces significant tax advantages and tax savings for these high-income taxpayers.

*House solution.*—The bill generally provides that a gain on the sale of farm property is to be treated as ordinary income to the extent of the taxpayer's previous farm losses. For this purpose, a taxpayer must maintain an excess deductions account to record his farm losses. In the case of individuals, farm losses must be added to the excess deductions account only if the taxpayer has more than \$50,000 of nonfarm income for the year and, in addition, only to the extent the farm loss for the year exceeds \$25,000. The amount in a taxpayer's excess deductions account would be reduced by the amount of farm income in a subsequent year.

The amount of farm losses recaptured on a sale of farm land would be limited to the deductions for the taxable year and the four previous years with respect to the land for soil and water conservation expenditures and land clearing expenditures.

To the extent gain on the sale of farm property is treated under these rules as ordinary income, this would reduce the amount in the taxpayer's excess deductions account.

The recapture rules provided by the bill would not apply if the taxpayer elected to follow generally applicable business accounting rules (i.e., used inventories and capitalized capital expenses).

This provision applies to dispositions of farm property in years beginning after 1969.

*Arguments For.*—This provision will limit the tax advantages currently available in the case of farming operations by recapturing upon the sale of farm property the farm losses which the taxpayer had deducted from ordinary income. In addition, the provision would not affect the small bona fide farmer because of the high dollar limitations.

(2) The present farm tax accounting rules should not be allowed to continue because they have resulted in a tax abuse. By the use of these provisions, some high-income taxpayers have carried on limited farming activities (including racehorse breeding) as a sideline to obtain a tax loss which is deducted from their high-bracket nonfarm income.

(3) These losses are not economic losses but arise instead from the deduction of capital costs which, under the tax laws applicable to most other industries, would reduce capital gains instead of offsetting ordinary income.

(4) The tax abuse in this area has become so large that in recent years a growing body of investment firms have advertised that they would arrange a farm loss for persons in high tax brackets. The advertising emphasizes the fact that "after tax" dollars may be saved by the use of "tax losses" from farming operations. Thus, these provisions have created an industry which manufactures farm "tax losses" as their stock in trade.

(5) The Treasury Department has submitted statistics for 1964, 1965, and 1966 which clearly demonstrates that the average "farm loss" on an individual basis increases as the taxpayer's adjusted gross income increases.



*Arguments Against.*—(1) The proposed change would complicate bookkeeping and accounting records which are kept by farmers. Farmers forced to comply with the new provision would have their operational costs increased because of the outside professional help which they would have to retain.

(2) It would also discourage the flow of risk capital to rural areas. Generally, in line with this argument is the statement that objectives (improved livestock strains, crop experimentation, etc.) of the U.S. Department of Agriculture are being accomplished less expensively than the Government could do it itself.

(3) The limitations provided by this provision are too high, with the result that the provision will have little, if any, application in the case of many persons using the farm loss provisions as tax shelters.

(4) This provision would have relatively little effect on the hobby loss farmer, since this type of farmer generally would realize fewer gains on farm property that would bring the recapture rules into operation.

## 2. Depreciation Recapture

*Present law.*—Present law provides that when a taxpayer sells personal property used in a business, there is a recapture of the depreciation claimed on the property. In other words, the gain on the sale of the property is treated as ordinary income, rather than capital gain, to the extent of the depreciation previously claimed. These rules do not apply, however, to livestock.

*Problem.*—The effect of the exclusion of livestock from the depreciation recapture rule is to allow a taxpayer to convert ordinary income into capital gain with substantial tax savings. This occurs because the depreciation is deducted currently from ordinary income taxed at the regular rates, but the gain on the sale of the livestock is taxed only at the lower capital gains rates.

*House solution.*—The bill eliminates the exception for livestock from the depreciation recapture rules. Thus, gain on the sale of livestock will be treated as ordinary income, rather than as capital gain, to the extent of the previous depreciation deductions.

This provision applies to years after 1969, but only to the extent of the depreciation taken after 1969.

*Arguments For.*—(1) This provision is favored because it eliminates the present disparity of treatment, as far as depreciation recapture is concerned, between livestock and other types of property used in a business.

(2) Taxpayers should not be able to use the present depreciation deduction rules for livestock to convert income taxed at ordinary rates into income taxed at capital gains rates.

*Arguments Against.*—(1) Present tax laws should not be made more stringent against the farm industry at a time when it is undergoing severe economic problems.

(2) An extension of the complicated depreciation recapture rules to the farm industry runs counter to the established position of the Federal government since 1916 to provide simple tax rules for farmers.

### 3. Holding Period for Livestock

*Present law.*—Present law allows gain on the sale of livestock held for draft, breeding, or dairy purposes to be treated as a capital gain, if the animal has been held by the taxpayer for one year or more.

*Problem.*—A one-year holding period allows taxpayers to make short-term, tax-motivated investments in livestock. For example, a taxpayer can go into the livestock business to build up a breeding herd over a short period of time, currently deduct the expenses of raising the animals against his other income which is taxed in the high bracket, and then sell the entire herd at the lower capital gains rates.

*House solution.*—The bill extends the required holding period for livestock. Livestock will not qualify under the bill for capital gains treatment, unless the animal has been held by the taxpayer for at least one year after it normally would have been used for draft, breeding, or dairy purposes. The present one-year rule, in effect, still applies where an animal is purchased after it has reached the qualifying age.

The bill also extends this holding period requirement to livestock held for sporting purposes, such as horse racing.

This provision applies to livestock acquired after 1969.

*Arguments For.*—(1) The holding period for livestock, in order to qualify for the capital gain rate, should be increased because the present period is not long enough to resolve the question of whether the taxpayer is truly holding the animal for draft, breeding, or dairy purposes or whether he is holding it for sale in the ordinary course of business. The intentions of the taxpayer would be more clear if the taxpayer is required to hold the animal for at least one year after the animal has reached the age when it would normally have first been used for draft, breeding or dairy purposes.

(2) The bill correctly reserves capital gain classification until the taxpayer has clearly begun to hold such animals as capital assets.

(3) This provision is favored on the grounds that by extending the required holding period for livestock, it will lessen the attractiveness of short-term, tax-motivated investments in livestock.

*Arguments Against.*—(1) Present tax rules should not be made more stringent against the farm industry at a time when it is undergoing severe economic problems.

(2) Under present law the holding period for farm animals is one year, or twice the amount of the holding period required for other types of capital assets (six months). Although other provisions of the bill would increase the general holding period for capital assets to one year, this provision would discriminate against many raised farm animals by increasing the holding period for them, in some cases, to periods in excess of three years (three times the general period).

(3) Questions are raised as to whether the holding period provided by the bill is, in fact, sufficiently long to significantly decrease the present tax advantages of livestock operations (i.e., whether it is appreciably longer than the period for which a tax-motivated investor otherwise would hold livestock).

### 4. Hobby Losses

*Present law.*—Present law contains a so-called hobby loss provision which limits to \$50,000 per year the amount of losses from a "business" carried on by an individual that he can use to offset his other income.

This limitation only applies, however, if the losses from the business exceed \$50,000 a year for at least five consecutive years. Moreover, certain specially treated deductions are disregarded in computing the size of the loss for this purpose.

*Problem.*—This hobby loss provision generally has been of limited application because it usually is possible to break the required string of five loss years. In addition, where the provision has applied to disallow the deduction of a loss, the taxpayer has been faced in one year with a combined additional tax attributable to a five-year period.

*House solution.*—The bill replaces the present hobby loss provision with a rule which disallows the deduction of losses from an activity carried on by the taxpayer where the activity is not carried on with a reasonable expectation of profit. An activity would be presumed to have been carried on without this expectation of profit where the losses from the activity were greater than \$25,000 in three out of five years.

This provision applies to years beginning after 1969.

*Arguments For.*—(1) This provision will provide a more effective and reasonable basis than does present law for distinguishing between situations involving a business activity carried on for profit and situations where taxpayers are merely attempting to utilize losses from an operation to offset other income.

(2) The hobby loss provision presently in the tax law has been of very limited application because taxpayers have been able to rearrange their income and deductions to avoid the 5-year requirement of the present law.

(3) Some court decisions have adopted procedural rules in the farming cases which have made it difficult to show that the loss which the taxpayer has incurred was the result of a "hobby" rather than the result of legitimate business activity.

*Arguments Against.*—(1) The bill fails to recognize that farming generally is a risky operation and that substantial losses are frequently incurred in early years.

(2) The discouragement of risk capital in this industry would impair animal husbandry, and the development of new and better crop strains and farming techniques.

(3) By restricting the application of the presumption that an activity is not carried on for profit to cases where the loss from the activity exceeds \$25,000, the effectiveness of the provision in dealing with hobby loss situations may be unduly limited.

(4) This provision will result in farmers who experience losses (e.g., because of crop failures) being harassed by revenue agents seeking to apply this provision.

## E. LIMITATION ON DEDUCTION OF INTEREST

*Present law.*—Present law allows individual taxpayers an itemized deduction, without limitation, for all interest paid or accrued during the taxable year.

*Problem.*—The present deduction for interest allows taxpayers to voluntarily incur a substantial interest expense on funds borrowed to purchase growth stocks (or other investments initially producing low income) and to then use the interest deduction to shelter other income from taxation. Where a taxpayer's investment produces little or no

current income, the effect of allowing a current deduction for interest on funds used to make the investment is to allow the interest deduction to offset other ordinary income while the income finally obtained from the investments results in capital gains.

The principal reason why the 154 high-income nontaxable tax returns for 1966 paid no tax was the deduction allowed for "other interest" (that is, interest other than that on a home mortgage and other than interest incurred in connection with a business). In many of these cases, the interest deduction was substantially greater than the investment income and, thus, was used to shelter other income from taxation.

*House solution.*—The bill limits the deduction allowed individuals for interest on funds borrowed for investment purposes. The limitation does not apply to interest incurred in a trade or business. Under the limitation, a taxpayer's deduction for investment interest would be limited to the amount of his net investment income (dividends, interest, rents, etc.), plus the amount of his long-term capital gains, plus \$25,000.

Investment interest in excess of \$25,000 would first offset net investment income and then would offset long-term capital gain income (long-term gain offset in this manner would not be taken into account in computing the 50 percent capital gains deduction).

In the case of partnerships, these limitations apply at both the partnership and the partner levels.

A carryover for disallowed interest would be allowed under which the disallowed interest could be used to offset investment income (and capital gains) in subsequent years. The basic limitation, however, would be applicable in the subsequent years.

This provision applies to years beginning after 1969.

*Arguments For.*—(1) This provision would limit the use of the interest deduction in connection with funds borrowed for investment purpose as a means of offsetting noninvestment income, such as a salary. In other words, a taxpayer could not voluntarily incur a substantial interest expense in connection with what is initially a low income producing investment which eventually may result in capital gains and at the same time use the interest deduction to reduce his other taxable income.

(2) Interest on investment borrowing is a controllable expense as it is usually not necessary for a taxpayer to borrow substantial amounts for investment purposes and to incur the interest expense in connection with that borrowing. Accordingly, it is appropriate to place a limitation on the deduction for investment interest, matching the limitation on the deduction for controllable charitable contributions.

(3) A taxpayer who incurs current interest expense, substantially in excess of his current investment income, is interested not only in obtaining the resulting mismatching of income and the expense of earning that income but also in deducting the expense from ordinary income while realizing the income as a tax-favored capital gain.

(4) Examination of the tax returns, described by former Secretary of the Treasury, Joseph W. Barr, as reporting no income tax liability for many wealthy individuals for 1966, revealed that interest deductions were a principal contributing factor to their tax avoidance.

*Arguments Against.*—(1) The provision interferes with the long-standing principle behind the cash receipts and disbursements method of accounting that expenses are deducted when they are paid and income is taxed when it is received.

(2) Additional tax deductible record-keeping costs will be incurred to comply with this change.

(3) This limitation could adversely affect the stock or real estate markets where borrowed funds presently play an appreciable role. Additionally there are difficulties in distinguishing between investment interest and business interest which this provision may not adequately deal with. An example of this is the case where the taxpayer purchases 100 percent of the stock of a corporation. Although the limitation would appear to apply to this situation, it is questionable whether the purchase of the stock is made for investment purposes rather than for business purposes.

(4) This provision is unnecessarily harsh on legitimate investment transactions where good investment considerations, rather than tax considerations, are motivating factors.

## F. MOVING EXPENSES

*Present law.*—A deduction from gross income is allowed for certain moving expenses related to job-relocation or moving to a first job. The deductible expenses are those of transporting the taxpayer, members of his household and their belongings from the old residence to the new residence, including meals and lodging en route.

Two conditions must be satisfied for a deduction to be available. First, the taxpayer's new principal place of work must be located at least 20 miles farther from his former residence than his former principal place of work (or, if the taxpayer had no former place of work, then at least 20 miles from his former residence). Second, the taxpayer must be employed full time during at least 39 weeks of the 52 weeks immediately following his arrival at the new principal place of work.

Generally, the courts have held that reimbursements for moving expenses other than those which may be deducted are includible in gross income.

*Problem.*—Job-related moves often entail considerable expense in addition to the direct costs of moving the taxpayer, his family, and personal effects to the new job location. These additional expenses include certain costs of selling and purchasing residences, househunting trips to the new job location, and temporary living expenses at the new location while permanent housing is obtained.

Moreover, the 20-mile test allows a taxpayer a moving expense deduction even where the move may merely be from one suburb of a locality to another, and the 39-week test denies the deduction where a taxpayer is prevented from satisfying the test by circumstances beyond his control.

*House solution.*—The bill extends the present moving expense deduction to also cover three additional types of job-related moving expenses:

(1) travel, meals, and lodging expenses for pre-move househunting trips; (2) expenses for meals and lodging in the general location of the new job location for a period of up to 30 days after obtaining employment; and (3) various reasonable expenses incident to the sale of a residence or the settlement of a lease at the old job location, or to the purchase of a residence or the acquisition of a lease at the new job location. A limitation of \$2,500 is placed on the deduction allowed for these three additional categories of moving expenses. In addition, expenses for the househunting trips and temporary living expenses may not account for more than \$1,000 of the \$2,500.

The bill also increases the 20-mile test to a 50-mile test, and provides that the 39-week test is to be waived if the taxpayer is unable to satisfy it due to circumstances beyond his control. Finally, the bill requires that reimbursements for moving expenses must be included in gross income. These provisions generally apply to years beginning after 1969.

*Arguments For.*—(1) 'It is appropriate to give more adequate recognition in the tax law to additional moving expenses which are incurred in connection with job-related moves. Moving expenses to a new job location may be viewed as a cost of earning income. From this, it may be argued that expenses reasonably incident to a job-related move should be deductible as are direct moving expenses under present law.

(2) The present law unreasonably discriminates in favor of "old" employees who are reimbursed for their moving expenses, on the one hand, as contrasted to "old" employees who are not reimbursed and "new" employees, whether or not they are reimbursed, on the other. This is so because individuals in the former category are not required to report their reimbursements and include them in income for tax purposes. (Of course, they get no deduction for their expenses.)

(3) Mobility of labor is highly desirable and the more complete deduction provisions for moving expenses in the bill fosters such mobility.

*Arguments Against.*—(1) The general philosophy of the income tax law is to deny a tax deduction for personal, family and living expenses, and for capital expenditures. The bill violates this general rule, enlarges the present moving expense deduction and makes it more of a precedent for allowance of still other personal family or living expenses.

(2) Mobility of labor, though desirable, is not motivated by a tax deduction. If a job offer in another location is attractive on its own, or if job opportunities are scarce in the employee's present location, he will make a necessary move without a tax reward.

(3) Existing rules for "old" employees who are reimbursed by their employers for a move required by the employer—the only situation where tax relief is warranted—are adequate to prevent hardship where the move is beyond the employees' control.

(4) The allowance of a deduction for the additional moving expenses is primarily advantageous to the professional or managerial employee, who is most likely to move, as well as to incur substantially higher moving costs due to his more expensive mode of living.

(5) The dollar limitations on the additional moving expense deduction are unrealistically low.

## G. LIMIT ON TAX PREFERENCES

*Present law.*—Under present law, there is no limit on how large a part of his income an individual may exclude from tax as a result of the receipt of various kinds of tax exempt income or special deductions. Individuals whose income is secured mainly from tax-exempt State and local bond interest, for example, may exclude practically all their income from tax. Similarly, individuals may pay tax on only a fraction of their economic income, if they enjoy the benefits of accelerated depreciation on real estate. Individuals may also escape tax on a large part of their economic income if they can take advantage of the present special farm accounting rules or can deduct charitable contributions which include appreciation in value which has not been subject to tax.

*Problem.*—The present treatment, which imposes no limit on the portion of his income that an individual may exclude from tax, results in an unfair distribution of the tax burden. This treatment results in large variations in the tax burdens placed on individuals who receive different kinds of income. In general, high-income taxpayers, who get the bulk of their income from personal services, are taxed at high rates. On the other hand, those who get the bulk of their income from such sources as tax-exempt interest and capital gains or who can benefit from accelerated depreciation on real estate pay relatively low rates of tax. In fact, individuals with high incomes who can benefit from these provisions may pay lower average rates of tax than many individuals with modest incomes. In extreme cases, individuals may enjoy large economic incomes without paying any tax at all.

*House solution.*—The House bill provides a limit on tax preferences under which no more than 50 percent of the taxpayer's total income (adjusted gross income plus tax preference items) can be excluded from tax. The tax preference items to which this provision applies are: (1) tax-exempt interest on both new and old issues of State and local bonds (to be gradually taken into account over a 10-year period at a rate of one-tenth of the interest per year); (2) the excluded one-half of capital gains; (3) the untaxed appreciation in value of property for which a charitable contributions deduction is allowed; (4) the excess of depreciation claimed on real property over straight line depreciation; and (5) farm losses to the extent they result from the use of special farm accounting rules.

The limit on tax preferences applies only to taxpayers with at least \$10,000 of tax preference items for the year. A 5-year carryover is provided for disallowed preferences. This provision applies to years beginning after 1969.

*Arguments For.*—(1) The limit on tax preference is based on the premise that individuals generally should be required to pay tax on at least one-half of their economic income.

(2) The limit on tax preferences has the advantage of making sure that individuals generally pay tax on a substantial part of their

income. It, therefore, serves as a second line of defense against the avoidance of income taxes, to back up the first line of defense against such avoidance offered by the remedial provisions in the House bill which limit the scope of specific tax preferences.

(3) The bill corrects the unfair discrimination in present law which favors those taxpayers who derive their income from the ownership of property as contrasted with those who earn their living from wages and salaries.

(4) The present law improperly encourages investment of capital in certain areas for tax consideration rather than good business reasons and violates the principle that taxes should have a neutral impact on economic decisions.

(5) Many individuals with large incomes benefit from tax preferences to the extent that they pay lower average rates of effective tax than many individuals with moderate incomes. This makes a mockery of a tax system based on the ability to pay.

*Arguments Against.*—(1) This limitation is an imperfect substitute for direct action on the preferential income tax provisions which cause today's tax injustice. Each particular item of tax preference should be considered on its own merits and should be adjusted accordingly.

(2) Enactment of a limit on tax preference complicates present law by imposing a new income tax system on top of our present system thereby compounding the complexity of the tax laws and adding considerable administrative difficulties to the existing system.

(3) This new approach could become the forerunner of a gross receipts tax on all taxpayers.

(4) The bill raises a constitutional question as to the power of Congress to tax income from State and local government obligations, particularly obligations already outstanding.

(5) The bill is inadequate; the excess of percentage depletion over cost depletion and the excess of intangible drilling and development expenses over the deductions allowed under straight line depreciation should be added to the list of tax preference items subject to the limit on tax preferences.

(6) The limit on tax preferences will discourage charitable gifts.

(7) If Congress has seen fit to provide a specific tax benefit, there is no reason why it should be denied to some merely on the ground that it, in combination with other items, represents a large proportion of that individual's income.

(8) Since this limit will not affect individuals until the sum of their tax preference income equals one-half of their total income, it will still be possible for some individuals to exclude substantial amounts of tax preference income from tax.

## H. ALLOCATION OF DEDUCTIONS

*Present law.*—Under present law an individual is permitted to charge his personal or itemized tax deductions entirely against his taxable income, without charging any part of these deductions to his tax-free income.



*Problem.*—The fact that an individual who receives tax-free income or special deductions can charge the entire amount of his personal deductions to his taxable income in effect gives him a double tax benefit. He not only excludes the tax-free income from his tax base but he also, by charging all his personal deductions against his taxable income, reduces his tax payments on this taxable income. As a result, individuals with substantial tax-free income and special deductions and large personal deductions can wipe out much or all of their tax liability on substantial amounts of otherwise taxable income.

*House solution.*—The House bill provides that an individual must allocate his personal deductions between his taxable income and his tax preference items, to the extent that the latter exceed \$10,000.

For example, a taxpayer whose income is divided equally between his taxable income and his tax preference income is allowed to take only one-half his otherwise allowable personal deductions; the remaining half of such personal deductions are disallowed.<sup>1</sup>

The personal expenses which must be allocated include interest, taxes, personal theft and casualty losses, charitable contributions, and medical expenses.

The tax preference items taken into account for this purpose are the same as those included under the limit on tax preferences (see item G) except for certain modifications. Tax-exempt interest on State and local bonds issued before July 12, 1969, is not taken into account. In addition, unlike the limit on tax preferences, the allocation provision includes in the list of tax preference items the excess of intangible drilling expenses over the amount of the expenses which would have been recovered through straight line depreciation and the excess of percentage depletion over cost depletion.

Taxpayers apply the limit on tax preferences before allocating deductions. Any tax preferences included in taxable income as a result of the limit on tax preferences are treated as taxable income for purposes of allocating deductions.

The allocation provision applies to years beginning after 1969, except that in the first year to which it applies only one-half of the taxpayer's personal expenses must be allocated.

*Arguments For.*—(1) The allocation of deductions provision is supported on the grounds that personal deductions are in fact paid for out of an individual's entire economic income and not just his taxable income. For that reason the deduction should be allowed for these items only to the extent the income to which they relate is included in an individual's tax base.

(2) The allocation provision is specifically designed to minimize any possible unfavorable impact on State and local obligations since only interest on bonds issued in the future are taken into account and this interest income is brought in under the allocation provision only gradually over a 10-year period.

<sup>1</sup> This example, in order to illustrate the allocation in a simple manner, takes all tax preference income into account and, for allocation purposes, does not reduce such tax preference income by \$10,000 as under the bill.

(3) This provision helps correct the unfair discrimination in present law which favors those taxpayers who derive their income from the ownership of property as contrasted with those who earn their living from wages and salaries.

(4) The provision recognizes the desirability of a tax system in which no individual can avoid his fair share of the tax burden.

(5) The present tax improperly encourages investment of funds in certain areas for tax considerations rather than good business reasons and violates the principle that taxes should have a neutral impact on economic decisions.

*Arguments Against.*—(1) The primary intent of the provision is to tax tax-preferred income rather than disallowing deductions. It would be better to consider the various tax-preference items individually and to take whatever corrective action is necessary directly on those items.

(2) Enactment of a system which allocates deductions on the basis of the relation between taxable and tax-preferred items of income complicates the tax laws and adds considerable administrative difficulties to the existing system.

(3) The bill raises a constitutional question as to the power of Congress to tax (even indirectly) income from State and local government obligations.

(4) Since most of the so-called "preferences" in today's law involves conscious decisions by Congress to encourage specific types of investments, those provisions should not now be heedlessly diluted under the guise of tax reform.

## I. INCOME AVERAGING

*Present law.*—Under present law, income averaging permits a taxpayer to mitigate the effect of progressive tax rates on sharp increases in income. His taxable income in excess of 133 $\frac{1}{3}$  percent of his average taxable income for the prior 4 years generally can be averaged and taxed at lower bracket rates than would otherwise apply. Certain types of income such as long-term capital gains, wagering income, and income from gifts are not eligible for averaging.

*Problem.*—The exclusion of certain types of income from income eligible for averaging complicates the tax return and makes it difficult for taxpayers to determine easily whether or not they would benefit from averaging. In addition, taxpayers with fluctuating income from these sources may pay higher taxes than taxpayers with constant income from the same sources or fluctuating income from different sources. Finally, the 133 $\frac{1}{3}$  percent requirement denies the benefit of averaging to taxpayers with a substantial increase in income and reduces the benefits of averaging for those who are eligible.

*House solution.*—The House bill extends income averaging to long-term capital gains, income from wagering, and income from gifts. It also lowers the percentage by which an individual's income must increase for averaging to be available from 33 $\frac{1}{3}$  percent to 20 percent.

*Arguments For.*—(1) Permitting averaging for presently excluded income will result in simplification of the tax form and the averaging computation.

(2) In the case of capital gains, it is maintained that the 50 percent exclusion does not provide a form of averaging because it does not distinguish between taxpayers with fluctuating capital gains and those with constant capital gains, and therefore averaging for capital gains is appropriate.

(3) As the Internal Revenue Service has worked with the present income averaging provisions, it has become apparent that the administrative limitation of 133 $\frac{1}{3}$  percent may be relaxed to do more equity for those cases where income averaging is appropriate.

*Arguments Against.*—(1) Income should be accounted annually. This provision enlarges the present opportunity for taxpayers to avoid full taxation.

(2) The items excluded from averaging were excluded for good reason. Capital gains already is given favorable treatment because only 50 percent of the gains is taxed. Income from wagering should not be eligible for averaging because the receipt of such income should not be encouraged. Income from gifts should not be eligible for averaging since it does not result from any effort on the part of the taxpayer.

(3) The 133 $\frac{1}{3}$  percent requirement should not be reduced to 120 percent since this will allow averaging for unreasonably small increases in income.

(4) Liberalization of income averaging rules for persons who experience a substantial increase in their earnings should be deferred until income averaging rules are devised which will give relief to persons who experience a sharp decline in their earnings.

## J. RESTRICTED STOCK PLANS

*Present law.*—Present law does not contain any specific rules governing the tax treatment of restricted stock plans. Existing Treasury regulations generally provide that no tax is imposed when the employee receives the restricted stock. Tax is deferred until the time the restrictions lapse; at that time, only the value of the stock, determined at the time of transfer to the employee, is treated as compensation, provided the stock has increased in value. If the stock has decreased in value, then the lower amount at the time the restrictions lapse is considered to be compensation. Thus, under present regulations there is a deferral of tax with respect to this type of compensation and any increase in the value in the stock between the time it is granted and the time when the restrictions lapse is not treated as compensation.

*Problem.*—The present tax treatment of restricted stock plans is significantly more generous than the treatment specifically provided in the law for similar types of deferred compensation arrangements. An example of this disparity can be seen by comparing the situation where stock is placed in an employee's trust as opposed to the giving of restricted stock directly to the employee. In the employee trust situation, if an employer transfers stock to a trust for an employee and the trust provides that the employee will receive the stock at the end of 5 years if he is alive at that time, the employee would be treated as receiving, and would be taxed on, compensation in the amount of the value of the stock at the time of the transfer. However, if the employer, instead of contributing the stock to the trust, gives the stock directly to the employee subject to the restriction that it cannot be sold for 5 years, then the employee's tax is deferred until the end of the 5-year period. In the latter situation, the employee actually possesses the stock, and he can vote it and receive the dividends, yet his

tax is deferred. In the trust situation, he has none of these benefits, yet he is taxed at the time the stock is transferred to the trust.

*House solution.*—The House bill provides that a person who receives compensation in the form of property, such as stock, which is subject to a restriction generally is subject to tax on the value of the property at the time of receipt unless his interest is subject to a substantial risk of forfeiture. In this case, he is to be taxed when the risk of forfeiture is removed. The restrictions on the property are not taken into account in determining its value except in the case where the restriction by its terms will never lapse. Generally, this provision applies to property transferred after June 30, 1969.

*Arguments For.*—(1) The House bill provision is supported on the grounds that it eliminates the disparity of tax treatment between various forms of deferred compensation by bringing restricted stock plans within the rules that Congress set forth as being the appropriate means by which an employee could be given a shareholder's interest in the business.

(2) Restricted stock plans are essentially compensation to an executive for services rendered. They represent incentives to key employees, and in many cases represent a significant portion of a taxpayer's total compensation.

(3) The provision is needed to close a loophole through which highly compensated employees are paid part of their compensation under circumstances whereby tax can be put off until the employee is in a lower tax bracket.

(4) The stock option rules provide sufficient opportunity for employees to receive an interest in their employers' business, yet, these rules are undermined by the less stringent requirements of restricted stock plans.

*Arguments Against.*—(1) The tightening of the rules on restricted stock plans may discourage employees' stock ownership of their employers' business.

(2) The bill would immediately tax the receipt of property which, in many instances, cannot be sold or otherwise disposed of by the taxpayer to pay the tax.

(3) The bill, in the case of forfeitable stock would tax capital appreciation of the property as ordinary income.

(4) Restricted stock plans are not, in fact, deferred compensation arrangements, but rather are a means of allowing key employees to become shareholders in the business.

(5) It is necessary to have these preferred stock plans so as to obtain and retain key employees.

(6) These tax incentives increase the economic productivity of business; hence, the benefits to everyone concerned are increased.

(7) Little revenue appears to be involved; hence, there is no real benefit accruing from making a change.

## K. OTHER DEFERRED COMPENSATION

*Present law and problem.*—Under present law, the Internal Revenue Service has allowed substantial tax benefits to be obtained with respect to certain types of deferred compensation arrangements for key employees. These arrangements are not required to meet the qualifica-

tions prescribed in the tax law for qualified pension and profit-sharing plans, and they are often available only to highly paid employees. Generally, under these arrangements, employees are permitted to defer the receipt (and taxation) of part of their current compensation until retirement, when they presumably will be in lower income tax brackets.

The following example is typical of these arrangements: The employer and the employee enter into a 5-year employment contract which provides for a specified amount of current compensation and an additional specified amount of nonforfeitable deferred compensation. The deferred compensation is credited to a reserve account on the company books. It is accumulated and paid in equal annual installments in the first 10 years after the employee's retirement.

Deferral is available only with respect to unfunded arrangements. In the case of funded arrangements (that is, where the employee has an interest in property), the employee is taxed currently on the contribution (provided his rights are nonforfeitable) even though he cannot immediately receive it. There is no tax deferral, and the tax imposed on the additional compensation is determined by reference to the employee's current tax bracket.

*House solution.*—The bill provides that the tax on deferred compensation is to continue to be deferred until the time the compensation is received, but that a minimum tax is to be imposed on deferred compensation received in any year in excess of \$10,000. Generally, this minimum tax is the total increase in tax which would have resulted if the deferred compensation had been included in the taxpayer's income in the years in which it was earned. This provision does not apply to any nondiscriminatory pension or profit-sharing plan (whether funded or unfunded). Generally, this provision applies only to the portion of deferred compensation payments attributable to years beginning after 1969.

*Arguments For.*—(1) This provision is supported on the basis that the employee who receives deferred compensation has received, in most cases, a valuable contractual right on which an immediate tax could be imposed, and the bill represents a reasonable compromise between immediate taxation and complete deferral. The payment of the tax is deferred until the compensation is actually received, but the original marginal rate is preserved as a minimum rate.

(2) The tax treatment of deferred compensation should not depend on whether the amount to be deferred is placed in trust or whether it is merely accumulated as a reserve on the books of the employer corporation, because an unfunded promise by a large, financially established corporation is probably as sufficiently sound as the amount of deferred compensation which is placed in trust. Usually these benefits are not available to the average employee-taxpayer.

(3) The possibility of shifting income from high-bracket years to low-bracket years after retirement is generally available only to high-bracket and managerial employees who are in a financial position to demand them—not to the average employee.

(4) Another provision of this bill reduces maximum tax on earned income to 50 percent. With this lower rate, the incentive to seek deferral is lessened and the special tax treatment of deferred compensation can be ended without harsh consequences.

*Arguments Against.*—(1) Deferred compensation arrangements benefit small and medium sized companies who face economic uncertainties and possible future financial difficulties. This type of arrangement enables management to have a financial interest in the business enterprise, while at the same time it allows the company to have the use of the funds involved.

(2) Income should be taxed at the tax rates which apply to the year in which the income is received.

(3) The primary benefit of deferred compensation is forward averaging; that is, the employee is able to level out his income by shifting earnings from peak years to retirement years when he expects his other income to be lower. Forward averaging is not tax avoidance and there is no reason to prevent it.

(4) This provision will be difficult to administer.

(5) Deferred compensation benefits should be preserved as an incentive to executives.

## L. ACCUMULATION TRUSTS, MULTIPLE TRUSTS, ETC.

*Present law.*—A trust that distributes all its income currently to its beneficiaries is not taxed on this income; instead the beneficiaries include these distributions in their income for tax purposes.

An accumulation trust (a trust where the trustee is either required, or is given discretion to accumulate income for future distributions to beneficiaries), however, is taxed on its accumulated income at individual rates. When this accumulated income is distributed to the beneficiaries, in some cases they are taxed on the distributions under a so-called throwback rule. The throwback rule treats the income for tax purposes as if it had been received by the beneficiary in the year in which it was received by the trust. This throwback rule, however, only applies on the part of the distribution of accumulated income which represents income earned by the trust in the 5 years immediately prior to the distribution. In addition to this limitation, the throwback rule does not apply to certain types of distributions.

*Problem.*—The progressive tax rate structure for individuals is avoided when a grantor creates trusts which accumulate income taxed at low rates, and the income in turn is distributed at a future date with little or no additional tax being paid by the beneficiary. This result occurs because the trust itself is taxed on the accumulated income rather than the grantor or the beneficiary. This means that the income in question, instead of being added on top of the beneficiary's other income and taxed at his marginal tax rate, is taxed to the trust at the starting tax rate. The throwback rule theoretically prevents this result, but the 5-year limitation and the numerous exceptions substantially limit the effectiveness of the rule.

This avoidance device is compounded by the use of multiple trusts—the creation of more than one accumulation trust by the same grantor for the same beneficiary.

*House solution.*—The bill provides that in the case of accumulation trusts (including multiple trusts) the beneficiaries are to be taxed on distributions of accumulated income in substantially the same manner as if the income had been distributed to the beneficiaries when it was earned by the trust. The taxes paid by the trust on the income, in

effect, will be considered paid by the beneficiary for this purpose. A shortcut method of computing the tax on the distribution of accumulated income is provided under which the tax attributable to the distribution, in effect, is averaged over the number of years in which the income was earned by the trust. Distributions of income accumulated by a trust (other than a foreign trust created by a U.S. person) in years ending before April 23, 1964, are not subject to the new unlimited throwback rule. This provision applies to the distributions made after April 22, 1969.

The bill also provides that in the case of a trust created by a taxpayer for the benefit of his spouse, the trust income which may be used for the benefit of the spouse is to be taxed to the creator of the trust as it is earned. This provision is to apply only in respect to property transferred in trust after April 22, 1969.

*Arguments For.*—(1) The bill prohibits the avoidance of the effect of the progressive tax rates where a grantor creates a trust or multiple trusts, which accumulate income, pay tax on such income at a much lower rate than would the beneficiary and then distribute it to him at a later date with little or no additional tax being paid by the beneficiary, even though he may be in a high tax bracket.

(2) Under the present law, the Internal Revenue Service has been unable to successfully resolve the problems presented by the use of multiple trusts. In some cases the courts have upheld the validity of such trusts.

(3) Accumulation trusts will be placed in substantially the same tax status as beneficiaries of trusts which distribute their income currently.

(4) This approach provides essentially the same treatment as has been applicable to foreign accumulation trusts created by U.S. persons since the passage of the Revenue Act of 1962.

*Arguments Against.*—(1) These provisions would be extremely difficult to administer and enforce by the Internal Revenue Service and on the part of the trustees.

(2) The abuse in this area involves multiple trusts and it is harsh to correct it in a way that upsets the normal fiduciary use of accumulation trusts.

(3) This provision will result in harsh tax consequences in the case of accumulation trusts which were established for nontax reasons, such as to postpone the receipt of funds by the beneficiary until he had reached a responsible age.

## M. MULTIPLE CORPORATIONS

*Present law.*—There are several provisions in the code which are designed to aid small corporations. The most important of these provisions is the surtax exemption. As the result of the surtax exemption corporations are taxed at only 22 percent, instead of at 48 percent on the first \$25,000 of taxable income.

Present law permits a controlled group of corporations to each obtain a \$25,000 surtax exemption if each of the corporations pays an additional 6 percent tax on the first \$25,000 of taxable income.<sup>1</sup> This

<sup>1</sup> The election to take multiple surtax exemptions and to pay the additional 6 percent tax is generally desirable where the group has a combined income of about \$32,500 or more. Below this figure the allocation of a single surtax generally produces a lower tax.

generally reduces the tax savings of the surtax exemption from \$6,500 to \$5,000.

Other provisions in the code designed to aid small corporations include: (1) the provision which allows a corporation to accumulate \$100,000 of earnings without being subject to the penalty tax on earnings unreasonably accumulated to avoid the dividend tax on shareholders; and (2) the provision which allows an additional first year depreciation deduction equal to 20 percent of the cost of the property (limited to \$10,000 per year).

*Problem.*—Large corporate organizations have been able to obtain substantial benefits from these provisions by dividing income among a number of related corporations. Since these are not in reality "small businesses" it is difficult to see why they should receive tax benefits intended primarily for small business.

*House solution.*—The House bill provides that a group of controlled corporations may have only one of each of the special provisions designed to aid small corporations. A controlled group of corporations is limited to one \$25,000 surtax exemption and \$100,000 accumulated earnings credit after an 8-year transition period. This is accomplished by gradually reducing the amount of the special provisions in excess of one which is presently being claimed by a controlled group over the years 1969 to 1975 until these excess special provisions are reduced to zero for 1976 and later years. The limitation on multiple benefits from the investment credit and first year additional depreciation, becomes fully effective with taxable years ending on or after December 31, 1969.

To ease the transition, controlled corporations are allowed to increase the dividend received deduction from 85 percent to 100 percent at a rate of 2 percent per year. In addition, controlled corporations who elect to file consolidated returns, may deduct net operating losses for a taxable year ending on or after December 31, 1969, against the income of other members of such group. Present regulations allow such losses to be deductible only against the income of the corporation which sustained the losses.

The bill also broadens the definition of a controlled group of corporations.

*Arguments For.*—(1) Large economic units have been able to reap unintended tax benefits through the use of multiple corporations. Often the only reason for using multiple corporations is to take advantage of the surtax exemption or the \$100,000 accumulated earnings credit. This may lead to uneconomic practice and a great waste of energy by taxpayers, their counsel, and the Internal Revenue Service. By structuring a large economic unit so as to generate no more than \$25,000 of taxable income in each component corporation, the maximum marginal tax can be held at 28 percent instead of 48 percent, thus, avoiding tax of \$5,000 for each corporation.

(2) Even where there are good business reasons for using multiple but related corporations they still should not be given the tax benefits designed for small business.

(3) This provision will prevent the artificial incorporation of many companies that actually perform the same or similar operations under one management.



(4) Under the present law, large businesses, such as various chain stores, are able to take advantage of the multiple surtax exemption while competing smaller businesses in local communities are not. This presents an element of unfair competition which the bill eliminates.

*Arguments Against.*—(1) The repeal of the multiple surtax exemption would discourage legitimate and normal expansion of growing businesses within a controlled group which is established for sound business purposes.

(2) Multiple corporate structures arise for bona fide business reasons and not for tax reductions. Such corporations are formed to limit public liability, to comply with State requirements and to "tailor" themselves to the particular business operation involved. The tax law should not penalize these legitimate purposes.

(3) A new venture is often unprofitable in the early operation. By placing the new venture in a separate corporation, the losses can be recouped faster via the \$25,000 surtax exemption and the other benefits allowed.

(4) No competitive unfairness exists within the industries, some of whose members have traditionally been organized into separate corporations.

## N. CORPORATE MERGERS

### 1. Disallowance of Interest Deduction in Certain Cases

*Present law.*—Under present law a corporation is allowed to deduct interest paid by it on its debt but is not allowed a deduction for dividends paid on its stock or equity.

*Problem.*—It is a difficult task to draw an appropriate distinction between dividends and interest, or equity and debt. Although this problem is a long-standing one in the tax laws, it has become of increasing significance in recent years because of the increased level of corporate merger activities and the increasing use of debt for corporate acquisitions purposes.

There are a number of factors which make the use of debt for corporate acquisition purposes desirable, including the fact that the acquiring company may deduct the interest on the debt but cannot deduct dividends on stock. A number of the other factors which make the use of debt desirable are also the factors which tend to make a bond or debenture more nearly like equity than debt. For example, the fact that a bond is convertible into stock tends to make it more attractive since the convertibility feature will allow the bondholder to participate in the future growth of the company. The fact that debt is subordinated to other creditors of the corporation makes it more attractive to the corporation since it does not impair its general credit position.

Although it is possible to substitute debt for equity without a merger, this is much easier to bring about at the time of the merger. This is because, although stockholders ordinarily would not be willing to substitute debt for their stock holdings, they may be willing to do so pursuant to a corporate acquisition where they are exchanging their holdings in one company for debt in another (the acquiring) company.

In summary, in many cases the characteristics of an obligation issued in connection with a corporation acquisition make the interest

in the corporation which it represents more nearly like a stockholder's interest than a creditor's interest, although the obligation is labeled as debt.

*House solution.*—In general, the bill disallows a deduction for interest on bonds issued in connection with the acquisition of a corporation where the bonds have specified characteristics which make them more closely akin to equity.

The disallowance rule of the bill only applies to bonds or debentures issued by a corporation to acquire stock in another corporation or to acquire at least two-thirds of the assets of another corporation. Moreover, the disallowance rule only applies to bonds or debentures which have all of the following characteristics: (1) they are subordinated to the corporation's trade creditors; (2) they are convertible into stock; and (3) they are issued by a corporation with a ratio of debt to equity which is greater than two to one or with an annual interest expense on its indebtedness which is not covered at least three times over by its projected earnings.

An exception to the treatment provided by the bill is allowed for up to \$5 million a year of interest on obligations which meet the prescribed test.

This provision of the bill also does not apply to debt issued in tax-free acquisitions of stock of newly formed or existing subsidiaries, or in connection with acquisitions of foreign corporations if substantially all of the income of the foreign corporation is from foreign sources.

This provision applies to interest on indebtedness incurred after May 27, 1969.

*Arguments For.*—(1) This provision helps stem the tide of conglomerate mergers, which have increased phenomenally in recent years and which pose a threat to our economic well-being, by denying the interest deduction with respect to certain types of indebtedness incurred by corporations in acquiring the stock of other entities.

(2) The corporate bonds and debentures used in conglomerate acquisitions have characteristics, such as convertibility and subordination, which delineate the interest in the corporation which they represent more as equity than as debt. This bill properly treats them as equity interests.

(3) Advantageous tax provisions have spurred the "urge to merge" with the result that the Federal Government bears a portion of the carrying costs of many conglomerate acquisitions. This provision withdraws one of those advantages.

*Arguments Against.*—(1) Mergers are part of the American business complex. They represent growth and, in many instances, rejuvenate businesses and management, and nurture higher degrees of efficiency and competence.

(2) Debentures and bond issues represent debt in the business community and they should not be characterized as equity interests for tax purposes.

(3) If Congress desires to inhibit the merger movement, it should make all reorganizations taxable events—regardless of whether they are voluntary or involuntary, horizontal, vertical or pure conglomerate. Congress should not limit its examination to the tax treatment of conglomerate mergers, but should also consider those sections of the Code

which permit hosts of corporate mergers to proceed unburdened by any taxation.

(4) The increasing amount of debt used for corporation acquisition purposes and the economic implications of the merger trend warrant a broader approach than that embodied in the bill (i.e., a broader disallowance of the interest deduction).

(5) If this rule is appropriate in the case of acquisitions it also is appropriate where similar "debt" is issued for other purposes.

## 2. Limitation on Installment Sales Provision

*Present law.*—Under present law, a taxpayer may elect the installment method of reporting a gain on a sale of real property, or a casual sale of personal property where the price is in excess of \$1,000. The installment method, however, is available only if the payments received by the seller in the year of sale (not counting debt obligations of the purchaser) do not exceed 30 percent of the sales price.

Although the Internal Revenue Service has not ruled as to whether the installment method of reporting gain is available where the seller receives debentures, it is understood that some tax counsel have advised that the method is so available.

*Problem.*—The allowance of the installment method of reporting gain where debentures are received by a seller of property may result in long-term tax deferral which nearly approaches nonrecognition, rather than installment reporting. In other words, the gain on the debentures need not be reported until they mature, which may not be until 15 or 20 years later.

Moreover, the allowance of the installment method where debentures or other readily marketable securities are received by the seller of property is not consistent with the purpose for which the installment provision was adopted. This method presumably was initially made available because of the view that where a seller received a debt obligation he did not have cash, or the equivalent of cash, on hand which would provide him with funds to pay the tax due on the gain. This problem, however, does not exist where the seller receives readily marketable securities.

Present law is also unclear as to the number of installments which are required if a transaction is to be eligible for the installment sales provision. In other words, it is not clear whether the installment method may be used when there is only one or a limited number of payments which may be deferred for a long time.

*House solution.*—The bill places two limitations on the use of the installment method of reporting gain on sales of real property and casual sales of personal property.

First, bonds with interest coupons attached, in registered form, or which are readily tradable, in effect, are to be considered payments in the year of sale for purposes of the rule which denies the installment method where more than 30 percent of the sales price is received in that year.

The second limitation provided by the bill would deny the use of the installment method unless the payment of the loan principal, or the payment of the loan principal and the interest together, are spread relatively evenly over the installment period. This requirement would

be satisfied if at least 5 percent of the loan principal is to be paid by the end of the first quarter of the installment period, 15 percent is to be paid by the end of the second quarter, and 40 percent is to be paid by the end of the third quarter.

This provision applies to sales after May 27, 1969.

*Arguments For.*—(1) In view of the increase in merger activities in recent years, this provision is necessary, along with the other provisions relating to interest and original issue discounts, to withdraw tax incentives to merge.

(2) The limitations provided by this provision on the use of the installment sales method restrict the availability of the method to situations which are consistent with the purposes for which the installment method was adopted. In other words, a seller is treated as receiving cash when he receives something which is the equivalent of cash. In addition, a sale which involves a deferred payment, rather than installments, is not to be treated as an installment sale.

(3) The bill improves on the present law where ambiguity exists as to the number of installment payments which are required in order for a transaction to qualify for installment sale treatment. It sets forth the specific criteria to be followed.

*Arguments Against.*—(1) The present law relating to installment sales is clear enough to prevent any abuse. Where there is a transaction which provides for payment in installments, installment sales treatment should be allowed if it complies with the terms of the present law.

(2) The installment privilege should be available even where the debt instrument is readily marketable or where the payments are not spread relatively evenly over the period the debt is outstanding.

### 3. Original Issue Discount

*Present law.*—Under present law, original issue discount arises when a corporation issues a bond for a price less than its face amount. (The amount of the discount is the difference between the issue price and the face amount of the bond.) The owner of the bond is not taxed on the original issue discount until the bond is redeemed or until he sells it, whichever occurs earlier. In addition, only that portion of the gain on the sale of the bond equal to the part of the original issue discount attributable to the period the taxpayer has held the bond is taxed at ordinary income rates.

The corporation issuing the bond, on the other hand, is allowed to deduct the original issue discount over the life of the bond.

*Problem.*—Present law results in a nonparallel treatment of original issue discount between the issuing corporation and the bondholder. The corporation deducts a part of the discount each year. On the other hand, the bondholder is not required to report any of the discount as income until he disposes of the bond. Although it is likely that the discount will be deducted by the corporation, it is probable that much of the ordinary income is not being reported by the bondholders.

*House solution.*—The bill generally provides that the bondholder and the issuing corporation are to be treated consistently with respect to original issue discount. Thus, the bill generally requires a bondholder to include the original issue discount in income ratably over

the life of the bond. This rule applies to the original bondholder as well as to subsequent bondholders.

Corporations issuing bonds in registered form would be required to furnish the bondholder and the Government with an annual information return regarding the amount of original issue discount to be included in income for the year.

The bill also clarifies present law by providing that original issue discount may arise when a bond is issued in exchange for stock or other property.

This provision does not apply to bonds issued by a government or a political subdivision.

This provision applies to bonds issued on or after May 28, 1969.

*Arguments For.*—The present law encourages the use of bonds to acquire another corporation because where original issue discount is involved, the tax treatment between the issuing corporation and the person acquiring the bond is nonparallel—both receive a tax benefit. This provision would eliminate the tax benefit to the bond holder, discouraging the use of bonds in corporate mergers.

(2) The provision minimizes the possibility that original issue discount will never be taxed to the bondholder.

*Arguments Against.*—(1) The present law is adequate in the treatment of original issue discount and this provision at best, is an artificial way to discourage corporate mergers.

(2) A bondholder should not be taxed on original issue discount until the time when he, in effect, receives it; namely, when the bond is redeemed or when he sells the bond.

#### **4. Convertible Indebtedness Repurchase Premiums**

*Present law.*—Under present law, there is a question as to whether a corporation which repurchases its convertible indebtedness at a premium may deduct the entire difference between the stated redemption price at maturity and the actual repurchase price. The Internal Revenue Service takes the position that the deduction is limited to an amount which represents a true interest expense (i.e., the cost of borrowing) and does not include the amount of the premium attributable to the conversion feature. This part of the repurchase is viewed by the Revenue Service as a capital transaction analogous to a corporation's repurchase of its own stock for which no deduction is allowable. There is, however, a court case which holds to the contrary in that it allowed the deduction of the entire premium. In addition, court cases have been filed by taxpayers to test the validity of the Service's position on this matter.

*Problem.*—A corporation which repurchases its convertible indebtedness is, in part, repurchasing the right to convert the bonds into its stock. Since a corporation may not deduct the costs of purchasing its stock as a business expense, it would appear that the purchase of what, in effect, is the right to purchase its stock should be treated in the same manner.

*House solution.*—The bill provides that a corporation which repurchases its convertible indebtedness at a premium may deduct only that part of the premium which represents a cost of borrowing rather than being attributable to the conversion feature. Generally, the deduction

would be limited to a normal call premium for nonconvertible corporate debt except where the corporation can satisfactorily demonstrate that a larger amount of the premium is related to the cost of borrowing.

This provision generally applies to repurchases of convertible indebtedness after April 22, 1969.

*Arguments For.*—(1) This provision resolves the conflict between the Internal Revenue Service and the courts as to the amount of deductible interest expense allowable where a corporation repurchases its convertible indebtedness at a premium.

(2) This provision, in effect, treats a premium paid on the repurchase of convertible indebtedness as consisting of two elements, an interest cost and an amount paid for the right to purchase stock. It is appropriate to treat the amount paid for the right to purchase stock in the same manner as an amount paid for stock (i.e., no deduction is allowed for the amount).

*Argument Against.*—The premium, although it may not in its entirety be an interest expense, is an expense of carrying on a corporation's trade or business for which a deduction should be allowed.

## O. STOCK DIVIDENDS

*Present law.*—In its simplest form, a stock dividend is commonly thought of as a mere readjustment of the stockholder's interest, and not as income. For example, if a corporation with only common stock outstanding issues more common stock as a dividend, no basic change is made in the position of the corporation and its stockholders. No corporate assets are paid out, and the distribution merely gives each stockholder more pieces of paper to represent the same interest in the corporation.

On the other hand, stock dividends may also be used in a way that alters the interests of the stockholders. For example, if a corporation with only common stock outstanding declares a dividend payable, at the election of each stockholder, either in additional common stock or in cash, the stockholder who receives a stock dividend is in the same position as if he received a taxable cash dividend and purchased additional stock with the proceeds. His interest in the corporation is increased relative to the interests of stockholders who took dividends in cash. Under present law, the recipient of a stock dividend under these conditions is taxed as if he had received cash.

*Problem.*—In recent years, considerable ingenuity has been used in developing methods of capitalizing corporations in such a way that shareholders can be given the equivalent of an election to receive cash or stock, but at the same time permitting stockholders who choose stock dividends to receive them tax free. Typically, these methods involve the use of two classes of common stock, one paying cash dividends and the other stock dividends. Sometimes, by means of such devices as convertible securities with changing conversion ratios, or systematic redemptions, the effect of an election to receive cash or stock can be achieved without any actual distribution of stock dividends, and therefore without any current tax to the stockholders whose interests in the corporation are increased.

*House solution.*—The bill provides that a stock dividend is to be taxable if one group of shareholders receives a distribution in cash and there is an increase in the proportionate interest of other shareholders in the corporation. In addition, the distribution of convertible preferred stock is to be taxable unless it does not cause such a disproportionate distribution.

To counter the various devices by which the effect of a distribution of stock can be disguised, the bill gives the Treasury Department regulatory authority to treat as distributions changes in conversion ratios, redemptions, and other transactions that have the effect of disproportionate distributions.

The bill also deals with the related problem of stock dividends on preferred stock. Since preferred stock characteristically pays specified cash dividends, all stock dividends on preferred stock (except antidilution distributions on convertible preferred stock) are a substitute for cash dividends, and all stock distributions on preferred stock (except for antidilution purposes) are taxable under the bill.

These provisions apply (subject to certain transitional rules) to distributions after January 10, 1969.

*Arguments For.*—(1) This provision is supported on the basis that if a corporation in effect were permitted to offer both growth stock and current income stock to investors, the taxation of dividends at ordinary income rates would be seriously undermined, and there would be a substantial loss of revenue, exceeding \$1.5 billion a year. If this option were clearly permitted by statute, it is argued that most publicly held corporations would establish two classes of stock, one cash-dividend-paying stock and the other growth stock. The cash paying stock would tend to be held by exempt organizations and taxpayers in low tax brackets, and the growth stock would tend to be held by taxpayers in high brackets. The holders of the growth stock would normally realize their gains as capital gains (or without tax, if held until death).

(2) Giving investors the option to take taxable cash dividends or to permit earnings to accumulate without tax payment (but with a relative increase in the investor's equity interest) would provide them an option not available to those receiving earned income.

(3) By permitting corporations unlimited discretion to pattern their securities to fit various special situations, the present law facilitates the takeover of businesses and the growth of conglomerate enterprises.

(4) Existing regulations (promulgated January 10, 1969) fail to prevent all arrangements by which taxable cash dividends can be paid to some shareholders while others enjoy a tax-free increase in their proportionate ownership interest in the corporation.

*Arguments Against.*—(1) Stockholders should be allowed the choice of taking down taxable dividends or leaving the corporation's earnings to accumulate and thereby increasing their equity in the corporation. A corporation that gave investors this choice would find it easier to raise capital, both by broadening its appeal to investors and by decreasing the amount it pays out in dividends. Under present law, investors have the option to delay tax on investment earnings by investing in growth stocks that pay little or no dividends, although this choice is limited insofar as the corporation is concerned, since it must generally choose to offer its investors either growth or current income.

(2) The bill imposes a tax on common stockholders even in situations where their proportionate interests decline (or at least do not increase) because of the changing redemption or conversion rates attached to preferred stock.

## P. FOREIGN TAX CREDIT

*Present law.*—Under present law a U.S. taxpayer is allowed a foreign tax credit against his U.S. tax liability on foreign income. Generally, the amount of the credit is limited to the amount of U.S. tax on the foreign income.

There are two alternative formulations of the limitation on the foreign tax credit: the "per country" limitation and the "overall" limitation. Under the per country limitation, foreign taxes and income are considered on a country by country basis. Under the overall limitation, on the other hand, all foreign taxes and foreign income are aggregated.

Thus, under this limitation, foreign taxes in one country, in effect, can be averaged with lower foreign taxes in another foreign country.

### *Problem.*—A. *Foreign Losses:*

The per country limitation allows a U.S. taxpayer with losses in a foreign country to, in effect, obtain a double tax benefit. Since the limitation is computed separately for each foreign country, the losses reduce U.S. tax on domestic income, rather than reducing the credit for taxes paid to other foreign countries (as would occur under the overall limitation). When the business operation in the loss country becomes profitable, the income, in effect, is likely not to be taxed by the United States because a foreign tax credit is allowed with respect to that income.

### *Problem.*—B. *Foreign Tax-Royalties:*

Another problem which may arise under either limitation (but which primarily arises under the overall limitation) is the difficulty of distinguishing royalty payments from tax payments. This problem especially arises in cases where the taxing authority in a foreign country is also the owner of mineral rights in that country. Since royalty payments may not be credited against U.S. taxes, the allowance of a foreign tax credit for a payment which, although called a tax, is in fact a royalty, allows a taxpayer a larger credit than he should receive. Where the credit exceeds the U.S. tax on the income from the mineral production in the foreign country, the excess credit may be used to offset U.S. tax on income from other operations in that country, or on income from other foreign countries.

*House solution.*—The bill provides two additional limitations on the foreign tax credit.

### *A. Foreign Losses:*

First, a taxpayer who uses the per country limitation, and who reduces his U.S. tax on U.S. income by reason of a loss from a foreign country, is to have the resulting tax benefit recaptured when income is subsequently derived from the country. This is accomplished by taxing subsequent income from that country until, in effect, the previous tax benefit is recaptured (i.e., until tax has been imposed on an amount of income equal to the amount of the loss previously deducted from



U.S. income). Generally, the amount of the benefit recaptured in any one year is limited to one-half the U.S. tax which would have been imposed on the income from the foreign country for that year, in the absence of the foreign tax credit. The amount of the tax benefit not recaptured in a year because of this limitation would be recaptured in subsequent years. The bill also applies the recapture rule where the taxpayer disposes of property which was used in the trade or business from which the loss arose. In this case, the amount of the loss not previously recaptured is included in income when the property is disposed of.

#### *B. Foreign Tax-Royalties:*

The bill also provides a separate foreign tax credit limitation in the case of foreign mineral income so that excess credits from this source cannot be used to reduce U.S. tax on other foreign income. In other words, the foreign tax credit allowed on mineral income from a foreign country will be limited to the amount of U.S. tax on that income. Excess credits may be carried over under the normal foreign tax credit carryover rules and credited against U.S. tax in other years on foreign mineral income. This separate limitation applies (1) where the foreign country from which the mineral income is derived requires the payment of a royalty with respect to the income producing property, (2) where that country has substantial mineral rights in the income producing property, or (3) where that country imposes higher taxes on mineral income than on other income. The purpose of these criteria is to isolate these cases in which it is likely that the taxes, at least in part, represent royalties. This separate limitation does not apply where a taxpayer's foreign mineral income for a year is less than \$10,000.

The loss recapture rule applies to losses in years after 1969 and the separate foreign tax credit limitation on foreign mineral income applies to years beginning after the enactment of the bill.

#### *A. Foreign Losses:*

*Argument For.*—The foreign tax credit was designed to prevent the same income from being subjected to a double tax—once by the foreign country where the income was earned and a second time by this country; it was not intended to allow a double tax benefit, for example, where a foreign loss prevents the application of both foreign and domestic taxes on other domestic income. The amendment is needed to correct this loophole.

*Argument Against.*—This provision will tend to discourage new ventures by United States corporations in foreign countries.

#### *B. Foreign Tax-Royalties:*

*Arguments For.*—(1) Where a foreign government owns mineral deposits it makes little difference to the foreign government whether it demands royalties from the companies developing the deposits or assesses high taxes on the income they earn from those mineral deposits. For U.S. tax purposes, however, it is important that payments to a foreign government with respect to mineral deposits owned by that government be designated as a "tax" since foreign taxes are creditable against U.S. taxes while "royalties" are not. This amendment is needed to prevent these payments which may largely represent a "royalty" from being designated as "foreign taxes" in order to gain a U.S. tax advantage.

(2) The bill is desirable in that it recognizes the significant difficulties of ascertaining whether a payment labeled as a tax payment is, in fact, a tax or a royalty by limiting the major abuse which arises in this area, namely the use of excess foreign tax credits on mineral income to offset U.S. tax on other foreign income.

*Arguments Against.*—(1) A United States taxpayer with foreign mineral operations should not be penalized as compared to other U.S. taxpayers with other types of operations; if a foreign government imposes an income tax it should uniformly be treated as income tax for foreign tax credit purposes.

(2) Just because it is "difficult" to distinguish a true royalty and a tax is no reason to treat that portion of a "tax payment" made to a foreign government with respect to a mineral deposit it owns which is a true "tax" any less favorably than any other tax; by subjecting the entire payment to a separate limitation mineral taxes paid to a foreign government are discriminated against.

(3) The bill places further obstacles before U.S. companies competing with companies of other nations for the right to develop and control mineral production abroad; this hurts our balance of payments and can affect the share of worldwide oil reserves available to the free world.

(4) The general nature of the separate limitation on foreign mineral income may have the effect of denying a foreign tax credit for part of a tax payment even where no amount of the tax payment is, in fact, a royalty.

## Q. FINANCIAL INSTITUTIONS

### 1. Commercial Banks—Reserves for Losses on Loans

*Present law.*—Commercial banks, as a result of Revenue Ruling 65-92 (C.B. 1965-1, 112), now have the privilege of building up a bad debt reserve equal to 2.4 percent of outstanding loans not insured by the Federal Government. The 2.4-percent figure used for this purpose is roughly three times the annual bad-debt loss of commercial banks during the period 1928-47. In 1968, Revenue Ruling 68-630 (C.B. 1968-2, 84) clarified the loan base used for computing the allowable bad-debt reserve to include only those loans on which banks can suffer an economic loss.

*Problem.*—By allowing commercial banks to build up bad-debt reserves equal to 2.4 percent of uninsured outstanding loans, present law gives them much more favorable treatment than most other taxpayers. Section 166(c) of the Internal Revenue Code permits business taxpayers to take a deduction for a reasonable addition to a reserve for bad debts. Most taxpayers accumulate a bad-debt reserve equal to the ratio of the average year's losses to accounts receivable. The average loss is computed on the basis of losses for the current year and the 5 preceding years.

Commercial banks have the option of establishing their bad-debt reserves on the basis of their actual experience like other taxpayers. However, they generally elect to build up these reserves on the basis of the industrywide 2.4-percent figure permitted by Revenue Ruling 65-92. The extent of the favored tax treatment granted to commercial banks by this ruling is shown by the fact that if banks were subject to the same bad-debt reserve rules applying to taxpayers generally, they

would on the average be allowed to build up a bad-debt reserve of less than 0.2 percent of outstanding noninsured loans.

*House solution.*—The House bill provides that in the future the deduction allowed commercial banks for additions to bad debt reserves is to be limited to the amount called for on the basis of their own experience as indicated by losses for the current year and the 5 preceding years. Banks with bad debt reserves in excess of the amount allowable on the basis of their own experience (as of the close of the last taxable year beginning before July 11, 1969) will not be required to reduce these reserves. However, these banks will not be permitted to add to reserves until additions are justified on the basis of their own experience; and if such additions to reserves are not so justified they will be allowed in effect to deduct only actual bad-debt losses.

To provide an extra margin of safety to protect against the possibility of unusually large bad-debt losses, banks will be permitted to carry back net operating losses for 10 years instead of 3 years as under present law. In addition, commercial banks will be permitted, as under present law, to carry forward net operating losses for 5 years.

These provisions apply to years beginning after July 11, 1969.

*Arguments for.*—(1) The present bad debt reserves of commercial banks based on the 2.4-percent industrywide figure are in excess of the reserves needed in anything other than a catastrophic depression such as occurred in the early 1930's.

(2) The more generous loss carrybacks provided by the House bill should provide substantial protection to banks in the event of unusual losses.

(3) The administratively determined 2.4 percent formula is based generally on depression losses and ignores the many government policies since 1933, all designed to prevent a repetition of the financial chaos of that era. In light of these policies and in view of favorable banking experience since the depression, the present tax reduction for loss reserves is unreasonably generous.

*Arguments Against.*—(1) Banks should be encouraged to take every possible precaution, including the creation of adequate reserves, to assure depositors that their money is safe and that they will be able to protect against depression-scale losses. Without such assurance, confidence in the financial system could be threatened.

(2) Extension of the period for carrying bank losses back is no substitute for the strength and solvency which depression-related reserves convey, not only domestically, but in international financial circles as well.

## **2. Mutual Savings Banks, Savings and Loan Associations, etc.**

*Present law.*—Mutual savings banks, savings and loan associations, and cooperative banks are permitted to compute additions to their bad-debt reserves on the basis of their actual experience or under one of two alternative formulas (specified by the 1962 Revenue Act), whichever produces the greatest addition to the reserve. The two alternative formulas provide for the deduction of (1) 60 percent of taxable income, or (2) 3 percent of qualifying real property loans. Under the 60-percent method, a mutual institution is permitted to deduct each year an amount equal to 60 percent of its taxable income (computed before any bad-debt deduction). Under the 3-percent

method, an institution is permitted to deduct an amount sufficient to bring the balance of the reserve for losses on qualifying real property loans to 3 percent of such loans outstanding at the close of the taxable year, plus an amount sufficient to bring the balance of the reserve for losses on other loans to a "reasonable" amount.

A savings and loan association and a cooperative bank are entitled to use these special reserve methods only if they meet a comprehensive set of investment standards, which were established by Congress in the 1962 act to insure that the tax benefits are available only to those institution primarily engaged in the business of home mortgage financing. Mutual savings banks, however, are not subject to any investment standards under these tax provisions and may use the special reserve methods regardless of the amount of their investments in home mortgage financing.

*Problem.*—In 1952 Congress repealed the exemption of these institutions from Federal income tax and subjected them to the regular corporate income tax. At that time, however, these institutions were allowed a special deduction for additions to bad-debt reserves which proved to be so large that they remained virtually tax exempt. In the Revenue Act of 1962, Congress sought to end this virtual tax exemption by providing the special alternative methods for these institutions in the computation of their bad-debt reserve. Although these methods are more restrictive than prior law, they still provide highly favorable treatment for the bad-debt reserves of these institutions.

It was expected that most of these institutions would compute their deduction under the 60-percent method, which requires the payment of some tax, while the 3-percent method would be an alternative primarily benefitting a limited number of new or rapidly growing institutions. In practice, about 90 percent of the savings and loan associations use the 60-percent method, but most mutual savings banks use the 3-percent method and as a result have been able to avoid substantially all Federal income taxes.

*House solution.*—The bill revises the treatment of mutual savings banks and savings and loan associations in a number of ways. It amends the special bad-debt reserve provisions by eliminating the 3 percent method and reducing the present 60 percent method to 30 percent gradually over a 10-year period.

The bill also revises the present investment standard applicable to savings and loan associations by liberalizing the composition of the qualifying assets and by applying the standard to mutual savings banks, as well as the other mutual institutions, as the basis on which the percentage for the special deduction method is determined. This new investment standard is a flexible one which reduces the percentage (applied against taxable income to compute the bad debt reserve deduction) depending on the percentage of the assets invested in the qualifying assets—residential real property loans, liquid reserves, and certain other assets. The full percentage (presently 60, to become 30) is to be allowed generally only if the institution has a prescribed percentage (82 percent for savings and loan associations and 72 percent for mutual savings banks) of its investments in qualifying assets. The percentage is proportionately reduced where an institution's qualifying assets are less than the prescribed percentage of total assets, but if less than 60 percent of its funds are in qualifying assets, the

percentage deduction method may not be used. The bill also allows these institutions to compute additions to their bad debt reserves on the basis of the 6-year moving average of their own experience (which is the new method provided by the bill for commercial banks), rather than on the basis of the percentage deduction method.

The bill also extends the net operating loss carryback for these institutions from 3 to 10 years, which allows the spreading of losses over 15 years (10 years back and 5 years forward), and provides for the same treatment of new institutions as is provided for new commercial banks. Generally, this provision applies to years beginning after July 11, 1969, although various transitional rules also are provided.

*Arguments For.*—(1) Since the House bill increased appreciably the effective rate of tax for commercial banks, a somewhat comparable increase in the effective tax rate for these institutions also is necessary. This is accomplished by (a) the repeal of the 3-percent method which has allowed mutual savings banks to remain virtually tax-free, and (b) the percentage reduction in the formula (from 60 to 30). Although raising the effective rate of tax, these changes will still leave a significant margin of tax advantage for them over commercial banks, preserving the inducement for them to continue investing in real estate mortgages.

(2) This and the other changes provide an assurance that significant tax will be paid in most cases on the retained earnings of these institutions, while at the same time providing reserves consistent with the proper protection of the institution and its policyholders in the light of the peculiar risks of long-term lending on residential real estate which is the principal function of these institutions.

(3) Although savings and loan associations are required (as a condition to favored tax deductions) to invest large amounts of their deposits in home-oriented mortgages, mutual savings banks are not similarly controlled as to their investments. By subjecting mutual savings banks to an investment standard (even one more generous than that applicable to savings and loan associations) the bill restricts preferential tax treatment to those instances where some preference still appears warranted.

(4) By extending the carryback for net operating losses from 3 to 10 years (allowing 15 years for such losses), the bill adequately provides for large unexpected losses.

*Arguments Against.*—(1) Congress recognized in 1962 the 60 percent deduction rule offered insufficient protection to member-depositors of rapidly growing mutual thrift institutions and so it provided the 3 percent rule as an appropriate alternative. The bill reverses this conscious Congressional decision.

(2) Mutual savings banks do not possess the same home mortgage background as savings and loan associations and prior Congresses have wisely left their investment practices disassociated from heavy involvement in home mortgages.

(3) The unique nature of real estate mortgages (very long term) makes it difficult to liquidate them in times of financial stress and this justifies the present loss reserve rules applicable with respect to these investments.

(4) These changes will adversely affect home mortgage financing, contrary to the intent of Congress, because increased taxes will mean less funds for loans, a lower return, and less protection for depositors. This will further retard an industry already hard hit by high interest rates.

(5) With the growth in the deposits of mutual savings banks, they need additional reserves to provide necessary protection for their depositors.

(6) The more generous investment standard will lead to heavier involvement in fewer properties, thereby exposing depositors to greater risks.

### 3. Treatment of Bonds Held by Financial Institutions

*Present law.*—Commercial banks and mutual savings institutions receive special tax treatment in regard to their transactions in bonds and other corporate and governmental evidences of indebtedness. Like other taxpayers, they can treat long-term gains from such transactions as long-term capital gains for tax purposes. However, unlike other taxpayers, they can treat capital losses from such transactions as ordinary losses and may deduct such losses without limit from ordinary income.

*Problem.*—The present nonparallel treatment of gains and losses on bond transactions by financial institutions appears to have inequitable results.

Transactions of financial institutions in corporate and government bonds and other evidences of indebtedness do not appear to be true capital transactions; they are more akin to transactions in inventory or stock in view of the size of the bank holdings of these items and the extent of their transactions in them. Moreover, financial institutions now maximize their tax advantages by arranging their transactions in bonds in the light of existing market conditions in order to realize gains in selected years and losses in other years. This enables them to report their gains as capital gains for tax purposes and their losses as ordinary losses chargeable against regular income. The result is to permit financial institutions to reduce their taxable liability and to receive preferential treatment over other taxpayers.

*House solution.*—The House bill provides parallel treatment for gains and losses derived by financial institutions on transactions in corporate and governmental bonds and other evidences of indebtedness. Under the bill, financial institutions are to treat net gains from these transactions as ordinary income instead of as capital gains but they will continue to treat net losses from such transactions as ordinary losses as under present law. This provision applies to taxable years beginning after July 11, 1969.

*Arguments For.*—(1) This provision removes the preferential treatment accorded to financial institutions over other taxpayers in regard to transactions in corporate and government bonds. It would have been possible to treat financial institutions exactly like other taxpayers with regard to such transactions—that is, treat the gains as capital gains and the losses as capital losses. However, it is understood that the financial institutions preferred the ordinary income tax treatment provided by the House bill to consistent capital gains treatment for their bond gains and losses, because they want to continue to have the protection offered by ordinary loss treatment on their bond losses.

(2) The bill prevents banks from so arranging their affairs as to realize gains from their securities when they have no other income, and to preserve losses on these securities until years in which they are profitable.

*Arguments Against.*—(1) The bill will further depress an already weak securities market by discouraging banks from buying and selling securities and this will have an adverse impact on Treasury revenues.

(2) The existing law reflects a wise policy of treating losses realized by financial institutions on governmental and corporate securities as ordinary losses while encouraging banks to invest in such securities (and thus create a market for government bonds) by offering capital gains treatment on potential profits; changing the existing law can only serve to narrow the market for governmental securities, making Federal debt management more difficult.

#### 4. Foreign Deposits in U.S. Banks

*Present law.*—Present law provides special rules, for purposes of the income tax and the estate tax, for the treatment of U.S. bank deposits, and the interest thereon, of foreign persons.

In general the effect of these special rules is to exempt this type of interest income received by foreign persons from U.S. tax and to exempt the deposits from the estate tax. Under present law the special bank deposit rules are to cease to apply at the end of 1972. In other words, after 1972 the interest on these bank deposits otherwise would be subject to income tax and the bank deposits themselves would be subject to the estate tax.

*Problem.*—Congress provided, in 1966, that the special treatment accorded U.S. bank deposits of foreign persons should be terminated. It was believed, however, that an immediate elimination of the special rules might have a substantial adverse effect on the balance of payments. Accordingly, it was decided to postpone the elimination of the special rules until the end of 1972. In view of the continuing deficit in the balance of payments, it appears that our balance of payments situation might be adversely affected to a substantial degree if the special treatment were removed at the end of 1972.

*House solution.*—The bill provides that the special income tax and estate tax rules regarding U.S. bank deposits (including deposits with savings and loan associations and certain amounts held by insurance companies) of foreign persons are to continue to apply until the end of 1975.

*Arguments For.*—(1) Postponement of the termination date for the special bank deposits rule will forestall the possibility of an outflow of funds from the United States (in anticipation of the termination of the special status) and the resulting harmful effect on our balance of payments.

(2) The bill retains the long-term goal set by Congress in 1966 of eventually treating foreigners who deposit their money in U.S. banks in the same manner as U.S. citizens are treated with respect to their bank deposits, both under the income tax and the estate tax.

(3) The bill recognizes the desirability of continuing the present U.S. income tax exemption for interest paid on foreign-owned bank deposits—and the estate tax exemption with respect to the deposits—in order to encourage an inflow of foreign capital and thus help adjust our unfavorable balance of payments.

*Arguments Against.*—(1) The tax reform bill is designed to eliminate preferences in the tax law and make the tax burden more equal on all persons who have U.S. income and property; this feature of the bill runs counter to the objectives of tax reform and tax equity by continuing a pronounced preference in the tax law beyond the date when it would ordinarily end.

(2) Questions can be raised as to whether the termination of this special treatment, in fact, will have an appreciable adverse effect on the balance of payments.

## **R. DEPRECIATION ALLOWED REGULATED INDUSTRIES**

### **1. Accelerated Depreciation**

*Present law.*—Regulated industries may make the same elections as other taxpayers regarding depreciation of their business property. About half the regulatory agencies require utilities that use accelerated depreciation to “flow through” the resulting reduction in Federal income taxes currently to income. (Where the utility is earning the maximum allowed by law or regulations, this results in flowing through the tax reduction to the utility’s current customers.) Other agencies permit the utilities they regulate to “normalize” the deferred tax liabilities resulting from accelerated depreciation. (This involves the utility retaining the current tax reduction and using this money in lieu of capital that would otherwise have to be obtained from equity investments or borrowing.) Some agencies insist that utilities subject to their jurisdiction use accelerated depreciation for tax purposes and, in a few rate cases, such agencies have treated the utilities they regulate as though they used accelerated depreciation (and flowed through the resulting tax reduction), even though the utilities may have in fact used straight-line depreciation.

*Problem.*—The trends of recent years are shifts from straight line to accelerated depreciation and shifts from normalization to flow-through, often against the will of the taxpayer utilities. In general, flow through to customers doubles the revenue loss involved in shifting from straight-line to accelerated depreciation. It is understood that continuation of these trends would shortly lead to revenue losses of approximately \$1.5 billion. Consideration of legislative action in this area is complicated by the fact that many utilities do not have effective monopolies while others do; many utilities are in growing industries while others are losing ground; many utilities compete (to the extent they face any competition) only with other regulated utilities while others compete with businesses not subject to governmental rate regulation.

*House solution.*—The bill provides that, in general, utilities brought under these provisions will be “frozen” as to their depreciation practices. As to existing property: if straight-line depreciation is presently being taken, then no faster depreciation may be used; if the taxpayer is taking accelerated depreciation and is normalizing, then accelerated depreciation can continue to be taken only if the taxpayer continues to normalize; no change is required if the taxpayer is now on flow-through. As to new property: a taxpayer presently on straight line or presently on accelerated depreciation with normalization will be per-



mitted to take accelerated depreciation only if the tax benefits are normalized in the manner described above (otherwise such taxpayers must take only straight line depreciation); no change is made if the taxpayer is now on flow-through insofar as the same kind of property is involved. The bill also does not change the power of the agency, in the case of normalization, to exclude the normalized tax reduction from the base upon which the company's maximum permitted profits are computed. These rules apply to property used predominantly in the trade or business of the furnishing or sale of: electrical energy, water, sewage disposal services, gas through a local distribution system, telephone services (other than those provided by COMSAT), or transportation of gas, oil (including shale oil), or petroleum products by pipeline, if the rates are regulated by a utilities commission or similar agency.

The changes apply to taxable years ending after July 22, 1969.

*Arguments For.*—(1) The bill substantially forestalls the entire revenue loss that continuation of existing trends would have made almost inevitable. It does so in a way that (with very few exceptions) will require no increase in utility rates because of the tax laws, since by and large, it merely takes the various regulatory situations as it finds them and freezes those situations.

(2) Although regulatory commissions have adopted widely varying rules relating to the depreciation policies, this change will assure uniform tax rules for all affected utilities in the future.

*Arguments Against.*—(1) The change will deny to some utility taxpayers the tax benefits of accelerated depreciation which are available to other taxpayers. The denial would be inconsistent and discriminatory.

(2) The bill is discriminatory against rate-payers to the extent that utilities under present law may adopt accelerated depreciation on their investments and "flow-through" the tax deferral to these ratepayers.

(3) This change infringes upon the authority of the various Federal and State commissions to regulate the accounts, financial reports, and rates of the various utilities which they are charged to supervise.

(4) Regulated utilities should be limited to straight line depreciation since they must expand services in accordance with their customers' needs and are protected from competition.

(5) All utilities should be permitted to elect accelerated depreciation with normalization, as a method for meeting competition by means that accord with generally preferred accounting standards.

## 2. Earnings and Profits

*Present law.*—A dividend is defined as a distribution of property by a corporation to its shareholders out of earnings and profits. If a distribution exceeds the corporation's earnings and profits, then the excess is a "tax-free dividend" (not currently taxable to the shareholder) which reduces his cost basis in the stock (increasing capital gain or reducing capital loss if the stock is sold by him). Earnings and profits in general are computed by reference to the method of depreciation used in computing the corporation's taxable income and so are reduced by the amount of depreciation deducted by the corporation on its return.

*Problem.*—Tax-free dividends (in effect, resulting in current avoidance of tax at ordinary income rates in exchange for possible postponed tax at long-term capital gains rates) appear to be increasing in a number of industries. Especially among utilities, a number of companies are regularly making such distributions. It was indicated that in 1968 private power companies alone made such tax-free distributions totaling approximately \$260 million. Statistical information is not readily available in the real estate industry on this point, but it is understood that substantial amounts of corporate distributions in this industry are also tax-free. Availability of these tax benefits is generally unrelated to the purposes of accelerated depreciation and is of greatest value to individuals in high tax brackets.

*House solution.*—The bill provides that, for the purpose of computing its earnings and profits, a corporation is to deduct depreciation on the straight line method, or on a similar method providing for ratable deductions of depreciation over the useful life of the asset. This provision would not affect the amount of depreciation that can be deducted in determining the corporation's Federal income tax.

This provision applies to earnings and profits for taxable years beginning after June 30, 1972.

*Arguments For.*—(1) This provision is supported on the ground that it is expected to put an end to the increasing practice of distributing tax-free dividends. It will not affect the corporations' tax liabilities but can affect the tax liabilities of the shareholders. It should end the use of this unintended substantial benefit to high-bracket taxpayers, which use is generally unrelated to the purposes for which accelerated depreciation deductions are made available to corporations.

(2) This rule regarding depreciation is essentially the same as what is currently required in the case of percentage depletion (where cost depletion is used for earnings and profits computations).

*Arguments Against.*—(1) The ability to distribute "tax-free dividends" is part of the structure of many corporations, and change in this regard will result in substantial reduction in the market price of those corporations' shares. It is noted, in reply, that three years are provided for market adjustments before the change takes effect.

(2) Accelerated depreciation is unlike percentage depletion in that it merely allocates the same amount of deductions over a different period of time—consequently, the earnings and profits treatment of percentage depletion should not be used as a model for the treatment of accelerated depreciation.

(3) Earnings and profits, for purposes of determining dividend distributions, should be computed by the same accounting rules used in determining income tax of the corporation. Eventually the amount of earnings and profit of a corporation from a particular investment should be the same whether the method of depreciation is an accelerated method or the straight-line method. The increase in the accumulated earning and profits in the latter years of the corporation should make up for the decreased earnings from the property in the earlier years.

## S. ALTERNATIVE CAPITAL GAIN RATE FOR CORPORATIONS<sup>1</sup>

*Present law.*—Corporations that have an excess of net long-term capital gains over net short-term capital losses may use the "alternative tax," which taxes the entire excess net long-term capital gain at 25 percent. Since the corporate tax structure is not graduated (as in the case for individuals) but is computed on the basis of a normal tax of 22 percent of taxable income and a surtax of 26 percent of that part of the taxable income which exceeds \$25,000, usually only those corporations with taxable incomes in excess of \$25,000 (on which the tax rate would be 48 percent, apart from the effect of the surcharge) use the alternative tax.

*Problem.*—The House bill eliminates the alternative tax for individuals, thereby raising their maximum capital gain rates. Accordingly, it appears appropriate to raise the corporate alternative tax rate to a greater percentage of the regular corporate tax rate. In addition, since corporations are not subject to graduated tax rates they usually do not encounter the problems of having bunched income, which has accrued over more than a one year period, taxed in one year at steeply graduated rates, which is one of the reasons for providing special tax treatment to capital gains.

*House solution.*—The bill increases the alternative tax rate which is applied to a corporation's net long-term capital gains from 25 to 30 percent. This provision applies to sales and other dispositions after July 31, 1969.

*Arguments For.*—(1) A corporation's capital gains, in comparison with those of an individual, are more in the nature of business income which is not essentially different from the corporation's other income.

(2) Because other changes in this bill provide that the alternative tax for individuals will be raised, in effect, to a maximum rate of 35 percent (scaling down later to 32.5 percent), a comparable adjustment should be made in the corporate tax on capital gains.

*Arguments Against.*—(1) This provision results in an economically undesirable redistribution of income from the corporate sector of the economy where it might be used for investment, to the individual sector where it might be used for consumption. This is so because the increase in revenues from this charge is used to provide tax relief to individuals.

(2) The 30 percent rate appears to be an arbitrary rate which was not developed from a study of corporate statistics.

## T. NATURAL RESOURCES

### 1. Percentage Depletion

*Present law.*—At present, percentage depletion is granted to a wide range of minerals. The depletion rates are 27½ percent for oil and gas wells; 23 percent for sulfur, uranium, and an extended list of minerals; 15 percent for metal mines, rock asphalt, vermiculite, and certain types of clay; 10 percent for coal and a limited group of other minerals; 7½ percent for clay, shale, and slate used for specified purposes; and 5 percent for such items as gravel, peat, and sand, and cer-

<sup>1</sup> Witnesses did not testify to this change in the law during the Ways and Means Committee hearings.

tain minerals from brine wells. In addition, a 15-percent rate applies to a final category which contains an extended series of minerals and also includes all other minerals unless sold for riprap, ballast road material, rubble, concrete aggregates, or for similar purposes. Percentage depletion is not granted in the case of soil, sod, dirt, turf, water, or mosses or minerals from sea water, the air, or similar inexhaustible sources.

Percentage depletion generally applies to the specified items regardless of whether the pertinent property is located in the United States or abroad. However, except for sulfur and uranium, the 23-percent percentage depletion rate applies only to deposits in the United States, and foreign deposits of the other minerals in this category are eligible for percentage depletion at the 15 percent rate.

The percentage depletion allowance is limited to a maximum of 50 percent of the taxable income from the property, computed before any allowance for depletion. In any case where depletion based upon cost is higher than percentage depletion, the higher amount is allowed as a deduction.

*Problem.*—Percentage depletion was adopted in 1926 when the prior allowances based on discovery value in the case of oil and gas proved difficult to administer and produced varying results. At that time, it was recognized that percentage depletion could permit taxpayers to recover amounts in excess of their investment. However, this was deemed justified on the ground it would have the beneficial effect of stimulating exploration for and discovery of new reserves of vitally needed oil and gas.

It has been charged that if percentage depletion rates are viewed as a needed stimulant at the present time they are higher than is needed to achieve the desired beneficial effect on reserves.

The application of percentage depletion allowances to income from oil and gas wells located in foreign countries has also been subject to criticism. It is charged that insofar as percentage depletion is intended primarily to encourage the exploration and discovery of new domestic wells, the granting of percentage depletion to income from foreign deposits results in a loss of revenue without commensurate advantages.

*House solution.*—The House bill affects percentage depletion in two ways. First, the various percentage depletion rates are reduced as follows:

[In percent]

	Present rate	Rate provided by bill
Oil and gas wells (domestic).....	27½	20
Sulfur and uranium, and specified minerals from domestic deposits.....	23	17
Gold, silver, oil shale, copper and iron ore from domestic deposits.....	15	15
Remaining minerals now at 15 percent.....	15	11
Asbestos, coal, sodium chloride, etc.....	10	7
Clay, shale and slate for specified uses.....	7½	5
Gravel, sand, and other minerals now at 5 percent.....	5	4

As can be seen from this table, the bill provides for substantial reductions in percentage depletion rates for most items. However, some

items—namely, gold, silver, oil shale, copper and iron ore—are to remain at the present 15 percent rate in the case of deposits in the United States.

Second, the bill provides that percentage depletion is not to be allowed for foreign oil and gas wells. These changes in percentage depletion allowances are effective for taxable years beginning after July 22, 1969.

*Arguments For.*—(1) The appropriate level of percentage depletion rates depends on a number of factors including the effect on incentives to discover new reserves, equity considerations involving the payment by each taxpayer of his fair share of taxes, and revenue considerations. This provision is supported on the ground that the new percentage depletion rates represent a better balance than now exists between all these objectives.

(2) Percentage depletion is symbolic of a preference-prone tax structure that discriminates against persons whose incomes are wholly or principally from fully taxable wages and salaries. To leave it unchanged would invite the breakdown of our voluntary, self-assessment system of taxation.

(3) The oil companies today do not pay a fair share of the Federal tax burden, largely because of percentage depletion.

(4) If stimulation of discovery and development of oil deposits to make the United States self-sufficient and independent of questionable supplies of foreign oil is a goal of percentage depletion, then the bill enhances that goal by doing away with percentage depletion on foreign oil.

*Arguments Against.*—(1) Oil and gas producers now pay heavy severance taxes to the States so that some measure of relief under the Federal income tax is appropriate.

(2) Receipts from withdrawals of oil, gas and mineral reserves are akin to receipts from the sale of a capital asset and should be given relief just as capital gains are given relief by being taxed at a special rate.

(3) Removal of percentage depletion from foreign oil and gas wells will not produce any significant additional revenue for the United States. This is because the foreign countries in which the wells are located will raise their taxes until the foreign tax credits allowed against U.S. tax absorb the increase in the U.S. tax resulting from the removal of percentage depletion.

(4) It is not percentage depletion rates in general that raise the charge of preferential treatment; rather, it is the specific 27½ percent rate applicable to oil and gas. By cutting the rates applicable to virtually all minerals the House bill unfairly portrays the entire mineral industry as the beneficiary of undeserved tax largess.

(5) Doing away with percentage depletion on foreign oil ignores the role the United States oil companies play in funnelling foreign oil earnings back to this country to benefit our suffering balance of payments. Similarly, it ignores the significance of expanding U.S. influence over oil reserves and keeping them available for the free world and out of Communist domination.

(6) Proved oil reserves today are declining at a rapid rate in this country, and there is insufficient new exploration. What the industry needs is more, not less, stimulation to seek new deposits.

(7) The true measure of an industry's profitability and tax burden is determined by reference to its gross income, not its net income, which is how most critics of the oil industry analyze it. Viewed in relation to its gross income the oil industry is less profitable, and more heavily taxed, than the average of other industries.

## 2. Mineral Production Payments

*Present law.*—A mineral production payment is a right to a specified share of the production from a mineral property (or a sum of money in place of the production) when that production occurs. Depending on how a production payment is created, it may be classified as a carved-out production payment, or retained production payment which may then be used in a so-called A-B-C transaction.

A carved-out production payment is created when the owner of a mineral property sells—or carves out—a portion of his future production. A carved-out production payment is usually sold for cash and, quite often, to a financial institution. Under present law, the amount received by the seller of the carved-out production payment generally is considered ordinary income subject to depletion in the year in which received. The purchaser of the production payment treats the payments received as income subject to the allowance for depletion (almost always cost depletion) and thus generally pays no tax on those amounts (except for that portion of the payments which is in the nature of interest). The amounts utilized to pay the production payment are excluded from income by the owner of the property during the payout period, but the expenses attributable to producing the income are deducted by him in the year they are incurred.

A retained production payment is created when the owner of a mineral interest sells the working interest, but reserves a production payment for himself. Under present law the owner of the retained production payment receives income for which percentage depletion may be taken during the payout period, or period during which he receives a part of the production (or a payment based on production). The purchaser of the working interest excludes the amounts used to satisfy the production payment during the payout period, but (until recently) deducted the cost of producing the minerals subject to the production payment.

The so-called A-B-C transaction is the same as a retained production payment case, except that after selling the working interest, the initial owner then sells the "retained production payment." Thus, in an A-B-C transaction, the owner of the mineral property, A, sells it to a second person, B, and reserves a production payment (bearing interest) for a major portion of the purchase price. He then sells the production payment to a third party, C, which is usually a financial institution, or, perhaps, a tax-exempt organization.

*Problem.*—It is charged that the use of carved-out production payments constitutes a problem because they are being employed to circumvent the limitations on the depletion deduction and the foreign tax credit and to distort the benefits that the net operating loss provisions were designed to provide. In addition, it is charged that in ABC

transactions, taxpayers are able to pay off what is essentially a purchase money mortgage with before-tax dollars rather than after-tax dollars.

*House solution.*—The bill provides in general that carved-out payments and retained payments (including ABC transactions) are to be treated as a loan by the owner of the production payment to the owner of the mineral property.

In the case of a carved-out production payment, the bill provides the payment is to be treated as a mortgage loan on the mineral property (rather than as an economic interest in the property). Thus, the proceeds received by the seller upon a sale of a production payment would not be taxable to him. However, as income is derived from the property subject to the carve out, that income would be taxable to the owner of the property, subject to the depletion allowance. The cost of producing minerals used to satisfy carved-out production payments would be deductible when incurred.

This treatment is not to apply to a production payment carved out for exploration or development of a mineral property if, under existing law, gross income is not realized by the person creating the production payment.

In the case of retained production payments (that is, the sale of mineral property subject to a production payment), the bill provides that the production payment is to be treated as a purchase money mortgage loan (rather than as an economic interest in the mineral property). Accordingly, the income derived from the property which is used to satisfy the payment would be taxable to the owner of the mineral property subject, of course, to the allowance for depletion. In addition, the production costs attributable to producing the minerals used to satisfy the production payment would be deductible by the owner of the working interest in the year incurred.

Generally this provision applies to production payments created after April 21, 1969.

*Arguments For.*—(1) In each of the three situations (the carved-out production payment, the retained production payment, and the ABC transaction, the transaction is similar in fact, to a loan transaction with the loan secured by a mortgage on the property and the "borrower" not personally liable for the loan.

(2) The use of production payments produce tax benefits that are in excess of the advantages Congress intended, in the case of the depletion deduction, the foreign tax credit, and the net operating loss carryover.

(3) Production payments enable taxpayers to avoid the 50 percent limitation on percentage depletion by accelerating the time when they realize income from the mineral property without also moving up the expenses related to the production of the minerals pledged to pay off the production payment. The bill will prevent this avoidance of the limitation.

*Arguments Against.*—(1) Mineral production payment transactions are not loans and to treat them as such distorts the generally accepted concepts of the terms "loan and mortgage." A production payment, it is argued, creates only a property right, and not a debtor-creditor relationship or the rights of a mortgage.

(2) To change the tax treatment of production payments would adversely affect the collateral securing existing loans and would further restrict the ability of the independent producers to finance their operations with the proceeds of new loans.

### 3. Mining Exploration Expenditures

*Present law.*—Present law allows a taxpayer to elect to deduct, without dollar limitation, mining exploration expenditures (that is, exploration expenditures for any ore or mineral other than oil or gas) which are made prior to the development stage of the mine. The availability of this deduction is limited to mines located in the United States or on the outer continental shelf. When a mine reaches the producing stage, the exploration expenditures previously deducted are recaptured, generally by disallowing the depletion deduction with respect to the mine.

A taxpayer who does not elect this unlimited mining exploration expenditure deduction is allowed a limited deduction for exploration expenditures (whether on domestic or foreign mines) without the recapture rules applying. The total deduction under this limited provision for all years may not exceed \$400,000.

*Problem.*—The allowance of a current deduction for exploration expenditures without applying the recapture rules in the case of expenditures for which the limited deduction is available provides more generous treatment than in the case of most mineral producers which are under the unlimited deduction provision. No reason is seen for this difference in treatment.

*House solution.*—The bill provides that the general recapture rules of present law are to apply to mining exploration expenditures (made after July 22, 1969) which are deducted under the limited provision of present law. Thus, a deduction will continue to be allowed for foreign or oceanographic explorations under the limited provision, but the general recapture rules will apply with respect to these expenditures.

*Arguments For.*—(1) A current deduction for exploration expenditures and, in addition, depletion on the property when the producing stage is reached should not be allowed on the same property.

(2) The bill continues the present privilege which taxpayers have of deducting foreign (and oceanographic) exploration expenditures subject to the same limitations as at present.

(3) The present law lacks uniformity in the tax treatment of exploration expenses in that mining companies which choose to deduct these expenses in excess of \$400,000 (and present law permits the taxpayer to elect to deduct greater amounts) are subject to a recapture of all their exploration expenses as the mine becomes profitable, while those which choose to limit their exploration expense deduction to \$400,000 would not be subject to the recapture. The bill provides uniform rules in this area by applying the recapture to *all* exploration expenses where the mines become profitable.

*Arguments Against.*—(1) The bill ignores the basis on which the existing law is predicated. Until 1966 exploration expense deductions were limited to \$400,000, but in that year Congress eliminated the limit (on an optional basis) principally to benefit the large companies and the special recapture rule was a *quid pro quo* for the higher de-



duction. Extension of the recapture rule to all exploration expenses now, in effect, makes small mining companies pay for the benefit extended to the large companies in 1966.

(2) Since some companies are willing to limit exploration expenditure deductions to \$400,000, they should not be subjected to the recapture rules.

#### 4. Treatment Processes in the Case of Oil Shale

*Present law.*—The depletion allowance for oil shale under present law is applicable only to the value of the rock itself—which has little if any value. Liquid oil from wells, on the other hand have considerable value.

*Problem.*—The industry will never develop in its use of oil shale until oil from shale receives more nearly the same percentage depletion allowance as oil produced from a well.

*House solution.*—The bill extends the point at which percentage depletion is computed in the case of oil shale to after extraction from the ground, through crushing, loading into the retort, and retorting, but not to hydrogenation, or any refining process or any other process subsequent to retorting.

*Argument For.*—Oil from shale should receive similar treatment to that given to oil produced from a well, that is on the value of liquid oil.

*Argument Against.*—This provision will allow percentage depletion to be taken on certain manufacturing processes performed in reducing oil shale to oil. The cut-off point should be at the completion of the mining from the ground.

### U. CAPITAL GAINS AND LOSSES

#### 1. Alternative Tax

*Present law.*—One-half of an individual's net long-term capital gains are included in taxable income and, accordingly, are taxed at regular tax rates. The alternative tax—a maximum of 25 percent on net long-term capital gains—is applied when an individual's marginal tax rate exceeds 50 percent. For married couples filing a joint return, the alternative tax is applied when other taxable income is greater than \$52,000. For single persons, the alternative tax is applied when other taxable income exceeds \$26,000.

*Problem.*—The incentive for many high income taxpayers to convert their income into capital gain is greater than for taxpayers subject to lesser rates because to the extent they do so the alternative tax rate for capital gains decreases their effective tax rate by more than one-half. This effect is associated with the extent that the taxpayer's income is greater than the level where the 50 percent marginal tax rate is effective.

*House solution.*—The bill eliminates the alternative tax rate for net long-term capital gains for individuals. The provision applies to sales and other dispositions made after July 25, 1969.

*Arguments For.*—(1) It is appropriate to remove the alternative capital gains rate to lessen the incentive for individuals to plan the conversion or ordinary income into capital gains.

(2) The alternative tax on capital gains benefits only the super-rich—those whose marginal income tax rate exceeds 50 percent—by

allowing them to, in effect, deduct more than 50 percent of their capital gain. The bill properly corrects this situation by assuring the same tax treatment for all capital gain income without regard to the individual's tax bracket.

(3) The alternative tax rate is at variance with the intent of the progressive rate structure which underlies our income tax laws. The bill more closely reflects the goal of taxing individuals according to their ability to pay.

(4) The alternative tax, because it is set at a maximum of 25 percent, operates to create an excessively large difference between the tax rate paid on capital gains and that paid on ordinary income by taxpayers in higher tax brackets.

*Arguments Against.*—(1) More liberal capital gains treatment is needed to spur the assumption of risk of enterprise and the responsibilities of ownership. For this reason, the alternative tax rate should be decreased rather than increased.

(2) An increase in the amount of the capital gain tax will reduce capital transactions, thereby reducing revenues to the Treasury at the very time other provisions of the bill are raising taxes.

(3) The effective tax rate for individuals with high taxable incomes may be increased by as much as 40 percent above present rates (from 25 percent to 35 percent).

## 2. Capital Losses of Individuals

*Present law.*—Under present law, both individual and corporate taxpayers may deduct capital losses to the extent of their capital gains. In addition, if an individual's capital losses exceed his capital gains, he may deduct up to \$1,000 of the excess loss against his ordinary income. (On the other hand, where an individual has a net long-term capital gain rather than a net capital loss, a maximum of only one-half of the net long-term capital gain is subject to tax.)

When a husband and wife each have capital transactions and a joint return is filed, their respective gains and losses are treated as though they had been realized by only one taxpayer and are offset against each other. On the other hand, when both spouses have capital losses and file separate returns, each spouse is allowed to deduct up to \$1,000 of net capital losses from ordinary income.

*Problem.*—The present treatment of long-term capital losses is inconsistent in the case of individuals with the treatment of their long-term capital gains. Although a maximum of fifty cents of each one dollar of long-term capital gains is subject to ordinary tax, when capital losses exceed capital gains, the excess loss is deductible dollar-for-dollar against ordinary income (up to a maximum of \$1,000).

In addition, when it is more advantageous to them, married couples can file separate returns, be treated as two separate taxpayers, and be allowed to deduct up to \$1,000 of capital losses from ordinary income. This treatment is permitted even though married couples are generally treated as one taxpayer. This treatment of losses tends to provide an advantage for people living in community property states because all gains and losses from community property are attributable in equal amounts to each of the spouses by operation of community property law and, therefore, they are automatically eligible for the benefit of the double deduction. On the other hand, spouses living in noncom-

munity property states must have separate losses in order to claim this advantage—hence, they must either sell assets held in their joint names or each must sell his own assets. (In addition, they must have equal incomes or the loss offset may be more than offset by a difference in tax as a result of this variation in income.)

*House solution.*—The House bill provides that only 50 percent of an individual's long-term capital losses may be offset against his ordinary income. (Short-term capital losses, however, would continue to be fully deductible.) In addition, the deduction of capital losses against ordinary income for married persons filing separate returns is limited by the House bill to \$500 for each spouse. These provisions apply to years beginning after July 25, 1969.

*Arguments For.*—(1) Taxpayers who are able to manage their investments to realize their gains and losses in different years are able to take advantage of the present disparity in treatment of gains and losses. Thus, they are able to take the 50 percent deduction for net-long-term capital gains in one year and to also take a full deduction for long-term capital losses in another year.

(2) The present treatment of capital losses also results in a special benefit to spouses who file separate returns to enable each to deduct up to \$1,000 of those losses from ordinary income. This advantage is automatic for persons in community property states, whereas, spouses living in non-community property states must either hold property in joint tenancy or own separate property before they may obtain this advantage. In addition, married persons in non-community property states who file separate returns must be willing to forego the split-income rates applicable to joint returns, while couples in community property states do not lose this advantage even though separate returns are filed.

(3) Present law discriminates against taxpayers whose investments are not readily marketable in favor of those taxpayers who can more freely manipulate sales of their investments to maximum advantage.

*Arguments Against.*—(1) An individual with a capital loss has suffered a loss in the full amount, and it is unfair to deny him the full benefit of this loss.

(2) If only a portion of an individual's net capital loss can be offset against his other income, the individual will be less willing to incur the risk of investment in new ventures and the economy will suffer.

(3) The bill fails to achieve consistency in treatment between capital gains and capital losses because while capital gains are taxed in full, only \$1000 of capital losses may be deducted from ordinary income annually. This provision of the bill should be deferred until the entire treatment of capital losses can be explored.

### **3. Collections of Letters, Memorandums, Etc.**

*Present law.*—Present law excludes copyrights and literary, musical, or artistic compositions (or similar property) from the definition of a capital asset, if they are held by the person whose efforts created the property (or by a person who acquired the property as a gift from the person who created it). Thus, gain arising from the sale of such a book, artistic work, or similar property is treated as ordinary income, rather than as capital gain. However, since collections of letters, memorandums, etc. (including those prepared for the individual) are

not excluded from the definition of a capital asset, gains from the sale of such property are accorded capital gains treatment.

*Problem.*—The rationale underlying the present law treatment of artistic works and similar property in the hands of the person who created them, in effect, is that the person is engaged in the business of creating the artistic work or similar property. In view of this, the gain arising from the sale of the property is treated as ordinary income, rather than as a gain from the sale of a capital asset.

It is difficult to see why this treatment should not extend to collections of letters, memorandums, etc., created by the person or prepared for or given to him. In the one case a person who writes a book and then sells it is treated as receiving ordinary income on the sale of the product of his personal efforts; in the one case, one who sells a letter or memorandum written by, or for, him is treated as receiving capital gain on the sale even though the product he is selling is, in effect, the result of his personal efforts.

*House solution.*—The House bill excludes letters, memorandums, and similar property from the definition of a capital asset, if they are held by a person whose efforts created the property or for whom the property was prepared or produced (or if received as a gift from such a person). Thus, the gain on a sale of these letters or memorandums would be treated as ordinary income, rather than as a capital gain. This provision applies to sales and other dispositions after July 25, 1969.

*Argument For.*—Collections of papers and letters are essentially similar to a literary or artistic composition which has been created by the personal efforts of the taxpayer. Both types of works should be classified in a similar manner for purposes of income taxation. It is logical to consider income from both these types of personal effort as income arising from the sale of property in the "ordinary course of a trade or business."

*Arguments Against.*—(1) Since other forms of earnings by an individual in some cases result in capital gains there is no reason for changing the treatment of such collections of letters, memorandums, etc., held by the person who created them, or for whom they were prepared or produced.

(2) If this kind of property is to be taxed it should be taxed as a capital gain in recognition of the fact that their value is attributable to work performed over a period longer than a single year.

#### **4. Holding Period of Capital Assets**

*Present law.*—Capital gains on assets held longer than 6 months are considered long-term gains. In the case of individuals, 50 percent of the excess of net long-term capital gains over net short-term capital losses is included in income. In the case of corporations, the excess is taxed at a maximum rate of 25 percent (30 percent under the bill) rather than at the regular 48 percent corporate rate.

*Problem.*—The distinction between the treatment of long and short term gains is based on the belief that gains which accrue over long

periods of time should not be taxed as ordinary income and that special treatment should be provided for investment, as opposed to speculative gains. The 6-month holding period does not appear to be an adequate implementation of either of these concepts. It affords special treatment to gains which accrue over a period of less than a year and it does not appear to adequately distinguish between speculative and investment gains.

*House solution.*—The House bill provides that a long-term capital gain is to be a gain from the sale or exchange of a capital asset held for more than 12 months. This provision applies to taxable years beginning after July 25, 1969.

*Arguments For.*—(1) Lengthening the holding period to one year is necessary to restore the original concept of the capital gains tax—that is, that these gains accruing over a period longer than one taxable year should not be “bunched” together and subjected to the graduated tax rates generally applicable to income normally received on an annual basis.

(2) A person who holds an investment for little more than six months is primarily interested in obtaining speculative gains from short-term market fluctuations which may be taxed at favorable rates. In contrast, the person who holds an investment for a long time probably is interested fundamentally in the income aspects of his investment, and in its long-term appreciation in value. The available evidence suggests that assets held for a period between six months and one year tend to be speculative. Further, a study made in 1962, of gains from corporate stock transactions revealed that almost 90 percent of all capital gains in that year arose from sales occurring after one year of possession. By fixing the holding period at one year the bill reflects all these considerations.

*Arguments Against.*—(1) Lengthening the holding period would cause investors in securities to postpone the sale of these securities. This, in turn, would seriously reduce the liquidity of the various securities markets and would reduce, as well, the Federal revenues from capital gains.

(2) Many persons believe that any lengthening of the holding period should be accompanied by a decrease in the maximum capital gain rate which would apply to such a gain.

## **5. Total Distributions From Qualified Pension, Etc., Plans**

*Present law.*—An employer who establishes a qualified employee pension, profit-sharing, stock-bonus, or annuity plan is allowed to deduct contributions to the trust, or if annuities are purchased, may deduct the premiums. The employer contributions to, and the earnings of, a tax-exempt trust generally are not taxed to the employee until the amount credited to his account are distributed or “made available” to him. Retirement benefits generally are taxed as ordinary income under the annuity rules when the amounts are distributed, to the extent they exceed the amounts contributed by the employee. Thus, employee contributions to a pension, etc. fund are not taxed

when received since these amounts were contributed from after-tax dollars of the employee.

An exception to the general rule of ordinary income treatment of pension benefits, however, provides that if an employee (except self-employed persons) receives his total accrued benefits in a distribution within 1 taxable year on account of separation from service or death, the distribution is taxed as a capital gain, rather than ordinary income.

If part or all of this total distribution consists of employer securities, the employee is not taxed on the net unrealized appreciation in the securities at the time of distribution but instead only when the stock is subsequently sold by the employee. The employee is taxed only on the portion of the employer securities attributable to the employer's cost at the time of the contribution to the trust. Furthermore, this portion is taxed at the long-term capital gains rate, rather than at ordinary income rates.

*Problem.*—The capital gains treatment of lump-sum pension distributions was originally enacted in the Revenue Act of 1942 as a solution to the so-called bunched-income problem of receiving an amount in 1 taxable year which had accrued over several years.

The capital gains treatment afforded lump-sum distributions from qualified pension plans allows employees to receive substantial amounts of deferred compensation at a much more favorable tax rate than other compensation received for services rendered. Moreover, it appears that the more significant benefits accrue to taxpayers with adjusted gross incomes in excess of \$50,000, and that a number of lump-sum distributions of \$800,000 to over \$1,000,000 have been made.

*House solution.*—The bill limits the extent to which capital gains treatment will be allowed for lump-sum distributions from qualified employees' trusts made within 1 taxable year. Capital gains treatment is to be limited to the amount of the total distribution in excess of employer contributions made during plan years beginning after 1969. Thus, amounts attributable to employer contributions made during plan years beginning after 1969 will be treated as ordinary income. This applies also to the amount of employer contributions of employer securities to the plan.

The bill also provides for a special 5-year "forward" averaging of the amounts to be treated as ordinary income. The taxpayer computes the increase in tax as a result of including 20 percent of the ordinary income amount of the distribution in his gross income for the taxable year in which the total distribution is made, and then multiplies the increase in tax by 5 to obtain his tax liability on the ordinary income portion. The bill further provides that the taxpayer may recompute his tax on the ordinary income portion at the end of 5 years by adding 20 percent of the amount in the gross income in each of the 5 taxable years, and if this method results in a lower tax than previously paid, he is entitled to a refund.

*Argument For.*—It is appropriate to treat at least the amount of the employer contributions to a pension trust (including contributions of employer stock) as ordinary income, since it is deferred compensation for services rendered over the period of employment which otherwise would be taxed as ordinary income. The bunched-income problem of treating this portion of the distribution as ordinary

income is alleviated by the special 5-year averaging provision of the bill.

*Arguments Against.*—(1) Opponents to any limitation on capital gains treatment of lump-sum pension distributions contend that the entire amount should continue to be taxed at capital gains rates, as they maintain that the fact that these amounts accrue over many years qualifies the distribution for special tax treatment.

(2) In the case of employer securities, the tax treatment of retirement plans involving these securities should be left unchanged because it is possible to consider an employee's participation in such a plan as if he had purchased the securities himself. Any change will be detrimental to the interests of the employees who have had the expectation of receiving capital gains treatment when they retire.

(3) The House bill does not go far enough in solving a basic tax inequity as a result of the tax advantage granted to lump-sum pension distributions in comparison with ordinary income treatment of all other pension distributions. There is other income in the lump-sum distribution which should appropriately be taxed as ordinary income, such as the dividends received on the trust accumulations.

(4) The present law properly taxes as a capital gain amounts received in one taxable year which are attributable to many taxable years.

## **6. Sales of Life Estates, Etc.**

*Present law.*—Under present law, when a life estate and remainder interest in property are acquired by gift, by bequest, or through inheritance, the basis of the property is divided between the life estate and the remainder. The owner of the life interest is not permitted to deduct any portion of his basis over the life of his interest and thereby to reduce for tax purposes the amount of income he receives from his interest. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

*Problem.*—This treatment of life estates has the effect of allowing a large portion, and in some cases, almost all of the income from a life estate or similar interest to avoid taxation in those situations where the life tenant sells his interest. This is because the life tenant is not taxed on his income to the extent of his basis and, in addition, the purchaser of this interest is not taxed on most of the income from it because he is allowed to reduce that income by amortization deductions for the purchase price which he pays for the interest. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible loss.

*House solution.*—The bill provides that the entire amount received on the sale or other disposition of a life (or term-of-years) interest in property, or an income interest in a trust (which was acquired by gift, bequest, inheritance, or by a transfer in trust), is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest. This provision applies to sales or other dispositions after July 25, 1969.

The House bill, however, does not change present law where a life interest is disposed of as part of a single transaction in which the entire fee interest is transferred (e.g., where a life tenant and remainderman simultaneously join in a sale of the entire property interest) to any person or persons. In such a case, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the disposition over his adjusted basis in the property.

*Argument For.*—The present tax law has the effect of allowing a large part, and in some cases almost all, of the income from a life estate to avoid taxation in those situations where the life tenant sells his interest. The life tenant is not taxed on the income he receives from the sale because he will usually have a tax basis equal to, or almost equal to, the sales price. This is regarded as particularly undesirable by those who view such transactions as an anticipatory assignment of income rather than as the sale of a property interest.

*Argument Against.*—A sale of a property interest is involved and therefore it is appropriate in measuring the amount of gain to reduce the proceeds by the amount of the life tenant's basis.

## 7. Certain Casualty Losses Under Section 1231

*Present law.*—Generally, under present law (sec. 1231(a) of the code), if the gains on the disposition of certain types of property exceed the losses on this same type of property, in effect, the excess is treated as long-term capital gain. On the other hand, if the losses exceed the gains, then the net loss is treated as an ordinary loss. The types of property subject to this provision generally are depreciable property and real estate used in a trade or business.

An exception to this general provision is provided for uninsured losses resulting from casualty or theft in the case of property used in a trade or business (or capital assets held for the production of income). These uninsured losses are deductible in full against ordinary income rather than being required to be netted with other gains and losses under section 1231.

*Problem.*—The exception to the general section 1231 rule has lead to anomalous results. A business taxpayer with a casualty loss on two similar business properties, one of which is insured and one of which is not, is allowed to deduct the uninsured loss in full against ordinary income and at the same time is allowed to treat the gain on the insured property (the excess of the amount of insurance received over his adjusted basis in the property) as a capital gain. In other words, the gain and loss do not have to be netted under section 1231. On the other hand, the netting is required where the business taxpayer only partially (perhaps 5 percent) insures a business property.

*House solution.*—The bill modifies the treatment of casualty losses and casualty gains under section 1231. Casualty (or theft) losses on depreciable property and real estate used in a trade or business and on capital assets held for the production of income are to be consolidated with casualty (or theft) gains on this type of property. If the casualty losses exceed the casualty gains, the net loss, in effect, will be treated as an ordinary loss (without regard to section 1231). On the other hand, if the casualty gains exceed the casualty losses, then the net gain will be treated as a section 1231 gain which must then be consolidated with other gains and losses under section 1231. This rule



is to apply where the casualty property is uninsured, partially insured, or totally insured. Although it was intended that casualty losses and casualty gains on capital assets which are personal assets, such as a personal residence or a nonbusiness automobile, were to be subject to this special rule, they were not included through a drafting error.

The bill also clarifies the fact that uninsured casualty losses on personal assets are subject to the basic section 1231 provisions.

This provision applies to years beginning after July 25, 1969.

*Argument For.*—This provision eliminates the present unrealistic distinction under section 1231 between insured and partially insured casualty losses. In addition, it eliminates the possibility that a business taxpayer can deduct an uninsured casualty loss on business property in full from ordinary income, when he also has a larger casualty gain on insured business property which would be treated as a capital gain.

*Argument Against.*—The bill fails to recognize the objective behind the original adoption of present law in the Technical Amendments Act of 1958—that is, that taxpayers who self-insure their property should be able to deduct their losses in full (without any type of reduction) against ordinary income in the year of the loss in a manner similar to taxpayers who insure their property with insurance companies, and who are able to deduct their insurance premiums against ordinary income (without any reduction) as they are paid.

## 8. Transfers of Franchises

*Present law.*—Questions have arisen under present law as to whether the transfer of a franchise is to be treated as an outright sale or as a mere license, and whether franchisors are selling franchises in the ordinary course of business. Depending upon how these questions are resolved, the franchisor will receive ordinary income or capital gains treatment on the gain he realizes on the transfer of a franchise. At present, these problems must be resolved under general tax principles, and this has produced different results: i.e., capital gains in some situations and ordinary income treatment in others, despite factual similarities in the interests in the franchises transferred.

*Problem.*—On several occasions the Tax Court has held that the transfer of subfranchises was not a sale for tax purposes and that all gains therefrom were to be taxed as ordinary income. This position of the Tax Court has been accepted generally by two Circuit Courts of Appeals; however, three other circuit courts have found sales to exist in similar transactions and have allowed franchisors capital gains treatment. Since present law does not specifically deal with the tax treatment of the transfer of a franchise, and since this has resulted in a considerable diversity of opinion among the courts as to whether the transfer of a franchise constitutes a license or a sale (and whether part or all of a sale of a franchise constitutes the sale of a capital asset) there appears to be a need for legislation in this area.

*House solution.*—The House bill denies a franchisor capital gains treatment on the transfer of a franchise if he retains any significant power, right, or continuing interest with respect to the subject matter of the franchise.

In the event the franchise agreement includes significant conditions or restrictions which are subject to the franchisor's approval on a continuing basis, this power to exercise continuing, active, operational

control over the subfranchise will constitute the franchisor's retention of a significant power, right, or continuing interest. Moreover, if the franchisor's conduct constitutes participation in the commercial or economic activities of the subfranchise then this conduct will be regarded as a retention of a significant power, right, or continuing interest. The rule provided by the bill, however, does not apply with respect to amounts received or accrued in connection with a transfer of a franchise which is attributable to the transfer of all substantial rights to a patent, trademark, or trade name, to the extent the amounts are separately identified and are reasonable in amount. These rules will apply to transfers made after July 25, 1969.

*Argument For.*—The substantial growth of franchising throughout the United States in recent years, and the split of authority among the courts with respect to the proper tax treatment to be accorded the transfer of a franchise, necessitates the adoption of more definite guidelines in this area so that where a franchisor does not part with all his interest in a franchise then the transfer will not be entitled to capital gains treatment.

*Argument Against.*—On the other hand, it is argued that most transfers of franchises are more like sales than licenses and, accordingly should continue to receive capital gains treatment.

## V. REAL ESTATE DEPRECIATION

*Present law.*—Under present law, the first owner may take depreciation allowances for real property under the double declining balance method or the sum-of-the-years-digits method. These rapid depreciation methods generally permit large portions of an asset's total basis to be deducted in the early years of the asset's useful life. A subsequent owner is permitted to use the 150 percent declining balance method which also provides more rapid depreciation than straight line in the early years.

Depreciation is allowed on the total cost basis of the property (minus a reasonable salvage value), even though the property was acquired with little equity and a large mortgage.

Net gains on sales of real property used in a trade or business are, with certain exceptions, taxed as capital gains and losses are treated as ordinary losses. Gain on the sale of buildings is taxed as ordinary income to the extent of depreciation taken on that property after December 31, 1963, if the property has been held not more than 12 months. If the property has been held over 12 months, only the excess over straight-line depreciation is "recaptured" and even that amount is reduced after 20 months, at the rate of 1 percent per month, until 120 months, after which nothing is recaptured.

*Problem.*—The present tax treatment of real estate has been used by some high income individuals as a tax shelter to escape payment of tax on substantial portions of their economic income. The rapid depreciation methods now allowed make it possible for taxpayers to deduct amounts in excess of those required to service the mortgage during the early life of the property. Moreover, because accelerated depreciation usually produces a deduction in excess of the actual decline in the usefulness of property, economically profitable real estate operations are normally converted into substantial tax losses, sheltering from

income tax such economic profits and permitting avoidance of income tax on the owner's other ordinary income, such as salary and dividends. Later the property can be sold and the excess of the sale price over the remaining basis can be treated as a capital gain to the extent that the recapture provisions do not apply. By holding the property for 10 years before sale, moreover, the taxpayer can arrange to have all the gain resulting from excess depreciation (which was offset against ordinary income) taxed as a capital gain without the recapture provisions coming into play. The tax advantages from such operations increase as a taxpayer's income moves into the higher tax brackets.

Because of the present tax situation, when investment is solicited in a real estate venture it has become the practice to promise a prospective investor substantial tax losses which can be used to diminish the tax on his income from other sources. Thus, there is, in effect, substantial dealing in "tax losses" produced by depreciable real property.

*House solution.*—The House bill revises real estate depreciation allowances to limit the opportunities to use the present treatment as a tax shelter and yet, at the same time, to maintain tax incentives to build low income housing where the need is great.

Under the bill the most accelerated methods of real estate depreciation (the 200 percent declining balance and the sum-of-the-years-digits methods) are limited to new residential housing. To qualify for such accelerated depreciation at least 80 percent of the income from the building must be derived from rentals of residential units. Other new real estate, including commercial and industrial buildings, is to be limited to the 150 percent declining balance depreciation method. In general the new rules will not apply to property if its construction began before July 25, 1969, or if there was a written binding contract to construct the building before July 25, 1969.

Only straight line depreciation is to be allowed for used buildings acquired after July 25, 1969. A special 5-year amortization deduction is provided in the case of expenditures after July 24, 1969, however, for the rehabilitation of buildings for low-cost rental housing.

Finally, the bill provides for the recapture of the excess of accelerated depreciation over straight line depreciation on the disposition after July 24, 1969, of depreciable real property (but only to the extent of depreciation taken after that date). Thus, to the extent of this excess depreciation, the gain on the sale of the real property will be treated as ordinary income rather than as capital gain.

*Arguments For.*—(1) This provision strikes a good balance between the need to curtail the availability of the real estate provisions as a tax shelter and the need to provide adequate incentives for the building of low income housing. Since the provision allows the most accelerated methods of real estate depreciation to be used for new residential housing, it continues the encouragement to build the residential housing needed to meet present housing shortages. On the other hand, by limiting new real estate other than residential housing to the 150-percent declining balance method, by limiting used buildings to straight line depreciation, and by strengthening the recapture provisions, the bill reduces the potential base of real estate as a tax shelter.

(2) Many economically profitable real estate operations produce substantial "tax losses" because of accelerated depreciation deductions

which are used to avoid income tax on the taxpayer's other income, such as salary and dividends, and in many cases result in the conversion of ordinary income into capital gain.

(3) Reducing depreciation deductions for slum and ghetto housing while continuing accelerated depreciation for new housing will make investments in slum housing less attractive and lead to its earlier demolition and replacement with modern housing, thus achieving a socially desirable goal.

(4) Recapturing real estate depreciation taken in excess of straight line depreciation at ordinary income tax rates not only simplifies this area of the tax law, but also it more closely recognizes that the larger deductions taken for depreciation reduced ordinary income (even though the property itself actually did not decrease in value) and should not now be allowed as a capital gain.

*Arguments Against.*—(1) There should be no change in the present tax treatment of real estate because of the pressing need to encourage the construction of more housing to eliminate the present housing shortages. This situation tends to imply that tax incentives have been deficient rather than excessive.

(2) Accelerated depreciation is a particularly appropriate incentive to real estate development in that it provides greater capital recovery during the uncertain earlier years when real property has to prove itself as a good or bad investment.

(3) The present recapture rules were carefully tailored to the peculiar requirements of the real estate industry and no case of favoritism has been established.

## W. COOPERATIVES <sup>1</sup>

*Present law.*—In determining taxable income under present law, cooperatives are permitted a deduction (or exclusion) for patronage dividends paid in money or in qualified patronage allocations. They also are permitted a deduction (or exclusion) for qualified per-unit retain certificates (that is, certificates issued to patrons to reflect the retention by the cooperative of a portion of the proceeds of the marketing of products for the patrons).

A patronage allocation, or per-unit retain certificate, is qualified—and therefore not taken into account by the cooperative—only if the patron consents to take it into account currently as income (or as a reduction in price in the case of purchases from the cooperative). Thus, in general, a cooperative is not taxed on patronage allocations or per-unit retains only if they are taxable to patrons. In the case of qualified patronage dividends, present law requires that 20 percent must be paid in money so that the patron will have all or part of the money to pay the tax.

*Problem.*—Qualified patronage allocations and qualified per-unit retains may be considered as amounts distributed by the cooperative to its patrons and reinvested in the cooperative as capital. However, the patron often does not have an independent choice between investing them in the cooperative or retaining them for his own use. This

<sup>1</sup> Witnesses did not testify to this change in the law during the Ways and Means Committee hearings.

choice is frequently made by the members as a group, and it may govern the use of a patron's funds even though he is not a member, or became a member after the cooperative's practices in this regard were established. Nevertheless, he is taxed as though he had full dominion over the entire patronage allocation or per-unit retain. Moreover, although most cooperatives revolve out these funds—on which the patron has already paid the tax—within 4 to 15 years, some cooperatives retain them indefinitely.

*House solution.*—Under the bill cooperatives are to be required to revolve out patronage dividends and per-unit retains within 15 years from the time the written notice of allocation is made or the per-unit retain certificate is issued. In addition, the percentage of patronage allocations which must be paid out currently in cash, or by qualified check, is increased from 20 percent to 50 percent. The additional 30 percent may be paid with respect to the current allocation or in redemption of prior allocations. The increase in the required payout is phased in ratably over a 10-year period. These provisions apply to taxable years beginning after 1969.

*Arguments For.*—(1) By requiring the cooperative to pay to the patron all of the patronage dividends or per-unit retains within 15 years, the bill assures the patron that he will eventually receive the patronage income on which he has been taxed. It is often argued, in fact, that the patron should receive this money earlier.

(2) Farmers today have little dominion over the treatment of patronage dividends despite the fact that they must pay tax on them as if they did. The bill will give them full control over one-half of the patronage dividend immediately with assurances that the remaining one-half (retained by the cooperative) will be paid out to them in 15 years. This greater control over the income on which they are taxed makes the tax more equitable.

(3) By requiring cooperatives to pay out more of their income currently the amounts they can retain tax-free for expansion of facilities in competition with fully tax-paying businesses is lessened. This is a desirable way of limiting the tax-free growth of business enterprises.

*Arguments Against.*—(1) The House bill fails to recognize the significance of the present rules whereby the patron in effect is given an option to accept the patronage dividend and pay a tax on it. Those rules were carefully devised to assure a single tax would always be collected on the earnings of cooperative enterprises and the bill does nothing to improve on present law in this respect.

(2) The bill ignores the role farm cooperatives play in improving the incomes of farmers by providing them with alternative methods of marketing their crops or of acquiring farm equipment, machinery and supplies at reasonable prices.

(3) There is no showing that the present balance between farm cooperatives and regular businesses should be upset to the detriment of the cooperative movement.

(4) The requirements for an early payout of patronage dividends and retains will impair the working capital of the cooperative, since these amounts represent, in effect, the cooperative's equity capital and serve as a base to support its borrowings.

## X. SUBCHAPTER S CORPORATIONS

*Present law.*—Subchapter S of the Internal Revenue Code was enacted in 1958 to provide tax relief for small business corporations (those with 10 or fewer shareholders) by allowing them to elect not to be taxed as a corporation, but instead to have the income or loss of the corporation taxed directly to the shareholders in a pattern roughly similar to that of partnership taxation. These provisions do not deal with employee retirement plans; consequently, subchapter S corporations may establish corporate retirement plans for the benefit of shareholders who are also employees of the corporation.

Prior to 1962, self-employed persons (proprietors and partners) were not able to establish such plans to benefit themselves. In 1962, however, Congress enacted the Self-Employed Individuals Retirement Act (H.R. 10), permitting self-employed persons to be treated as employees of the businesses they conduct so that they may be covered under qualified employees retirement plans in much the same manner as their employees. These provisions, though, contain certain specific requirements as to proprietors and partners which limit contributions to 10 percent of the proprietor's or partner's earned income, or \$2,500, whichever is less.

*Problem.*—The H.R. 10 limitations on retirement income plans described above (do not apply to corporations and so may be avoided by a proprietor or the partners of a partnership by forming a corporation, electing subchapter S treatment, and then becoming employees of the corporation. By the same token, a business that had incorporated without contemplating a subchapter S election can avoid the burden of the corporate tax while retaining its broad corporate retirement plans.

*House solution.*—The House bill provides limitations, similar to those contained in H.R. 10, with respect to contributions made by subchapter S corporations to the retirement plans for those individuals who are "shareholder-employees," defined as employees or officers who own more than 5 percent of the corporation's stock. Under the bill, a shareholder-employee must include in his income the contributions made by the corporation under a qualified plan on his behalf to the extent contributions exceed 10 percent of his salary or \$2,500, whichever is less. This provision applies to taxable years of subchapter S corporations beginning after 1969.

*Argument For.*—If an enterprise wants to incorporate for business purposes, but wants to be taxed in a manner similar to a partnership, then it should be subject to the same H.R. 10 limitations as partnerships in the case of pension plan contributions it makes on behalf of its owner-employees.

*Arguments Against.*—(1) Subchapter S corporations are in fact corporations; the subchapter S election doesn't entitle them to partnership taxation but rather to tax treatment in a manner similar to the partnership rules, and these special rules do not provide all the benefits of partnership taxation.

(2) H.R. 10 limitations are too restrictive and should be revised in a more reasonable manner possibly on a comparable basis with the corporate plans.

(3) The process of revising all the existing plans presents an unbearable burden.

(4) This change in the law should await a Congressional review of

the overall treatment of pension plan contributions and benefits, including the Treasury Department study of 1965.

## Y. TAX TREATMENT OF STATE AND MUNICIPAL BONDS <sup>1</sup>

*Present law.*—Interest payments on obligations of State and local governments generally are exempt from Federal income tax, an exemption that has been provided ever since the Federal income tax was adopted in 1913.

*Problem.*—The tax savings for individuals and corporations from the purchase of tax-exempt bonds has been greater than the differential between the interest yields on tax-exempt and taxable bonds. As a result, it has been estimated that the interest savings to State and local governments was \$1.3 billion in 1968, but the tax revenue loss of the Federal Government was \$1.8 billion.

In addition some State and local governments have issued arbitrage bonds whose proceeds are invested in Treasury bonds which pay a higher interest yield than the issuer's tax-exempt yield. The issuer retains the differential between the interest yields as an addition to its revenues.

*House solution.*—State and local governments are given the voluntary election to issue taxable bonds. If they make this choice, the Federal Government will pay between 25 and 40 percent of the interest on the bond (between 30 and 40 percent through the end of 1974). The Secretary of the Treasury will determine and publish the percentage for the Federal payment before the first day of each calendar quarter, and the percentage will apply for the entire life of all taxable bonds issued during that quarter. The Federal payments will be made under a permanent appropriation no later than the time when the issuing government must pay the interest on its bonds. This provision applies to issues made in calendar quarters that begin after the date of enactment.

Federal income tax exemption would no longer apply to arbitrage bonds issued after July 11, 1969.

*Arguments For.*—(1) The election to issue taxable bonds is voluntary on the part of State and local governments, and the Federal Government automatically makes the interest payments if they so elect. Since this provision is voluntary on the part of States and local governments none need elect it unless it works to their advantage.

(2) The Federal Government will have no powers of review over the purpose for which the bonds are issued or the capacity of the issuing government to repay its debt and, as a result, there will be no Federal control of the program.

(3) Because of the higher yield on the taxable bonds, the market for State and local bonds will be broadened.

(4) The Federal subsidy provided by the bill will be offset—possibly more than offset—by increased taxes as the portion of the interest on the bond paid by State municipal governments moves from nontaxable to taxable status.

(5) The provision would help eliminate the stimulus present tax exemption exerts on wealthy individuals to purchase State and local government obligations for tax reasons, thereby diverting their investments from areas more economically justified.

<sup>1</sup> See also discussion under Limit on Tax Preferences, page 47, and Allocation of Deductions, page 48.

*Arguments Against.*—(1) The provision opens the way to complete repeal of the State and local tax exemption.

(2) It does not avoid the constitutional question as to whether Congress has the power to tax the income from State and local obligations; if the Constitution prohibits the Federal Government from taxing these obligations the Constitution cannot be made inapplicable at the election of a State or municipal government. The provision is a further incursion of the Federal Government into the affairs of State and local governments and in this respect it runs counter to the goal of decentralized government.

(3) It is argued that commercial banks which are the most significant purchasers of tax-exempt bonds may reduce their purchases when the issues are taxable in light of other provisions in the bill that increase the effective rate of taxation on commercial bank net income.

## **Z. EXTENSION OF TAX SURCHARGE AND EXCISE TAXES; TERMINATION OF INVESTMENT CREDIT**

### **1. Extension of Tax Surcharge at 5-Percent Annual Rate for First Half of 1970.**

*Present law.*—The Revenue and Expenditure Control Act of 1968 adopted a 10-percent surcharge on the tax liabilities of individuals and business corporations in order to dampen inflationary pressures and keep the economy under control. The 10-percent surcharge expired as of June 30, 1969. H.R. 9951 extended the 10-percent surcharge for the period from July 1, 1969, through December 31, 1969.

*Problem.*—The extension of the surcharge until the end of calendar year 1969 provided by H.R. 9951 will help combat the inflationary pressures which are rampant in the economy. However, these inflationary pressures are now so strong that some extension of the surcharge through the first half of 1970 may be necessary in order to finish the job of bringing the economy under control. The gross national product is still rising sharply, the consumer price index and the wholesale price index have risen at an annual rate of over 6-percent since the end of last year and our financial and money markets are showing marked signs of strain.

*House solution.*—The House bill provides that the surcharge on the tax liabilities of individuals and corporations which, under H.R. 9951, is scheduled to expire on December 31, 1969, shall be continued at a 5-percent annual rate for the period from January 1, 1970, until June 30, 1970. Since this 5-percent surcharge will be applicable only for the first half of 1970, the surcharge for the entire year 1970 will be 2½-percent for a calendar-year taxpayer.

*Note.*—This provision was included in H.R. 12290, the bill to repeal the 7 percent investment tax credit, to extend the 10 percent income tax surcharge, and for other purposes. It was approved by the Committee on Finance when the Committee ordered that bill reported in July. For that reason no position for or against it is stated.

### **2. Continuation of Excise Taxes on Communication Services and Automobiles**

*Present law.*—The excise tax on passenger automobiles presently is 7 percent and the excise tax on local and toll telephone services and teletypewriter exchange services presently is 10 percent. Both rates



are scheduled to decline to 5 percent on January 1, 1970, 3 percent on January 1, 1971, 1 percent on January 1, 1972, and to be repealed on January 1, 1973.

*Problem.*—It appears inappropriate to reduce these excise taxes during a period of serious inflationary pressures when the Federal Government has imposed an income tax surcharge and is applying other forms of fiscal and monetary restraints to control the inflationary pressures.

*House solution.*—The scheduled reductions which were to begin on January 1, 1970, are delayed for 1 year. As a result, the 5 percent excise tax rates will become effective on January 1, 1971, the 3 percent rate on January 1, 1972, and the 1 percent rate on January 1, 1973, and the repeal of these excise taxes will take effect on January 1, 1974.

*Note.*—This provision was included in H.R. 12290, the bill to repeal the 7 percent investment tax credit, to extend the 10 percent income tax surcharge, and for other purposes. It was approved by the Committee on Finance when the Committee ordered that bill reported in July. For that reason no position for or against it is stated.

### **3. Repeal of the Investment Credit**

*Present law.*—Present law provides a 7-percent tax credit (3 percent for public utility property) for qualified investment in: (1) tangible personal property; (2) other property (not including buildings and structural components) which is an integral part of manufacturing or production, or a research or storage facility; and (3) elevators and escalators.

To qualify, the property must be depreciable and have a useful life of four years or more. New property fully qualifies for the credit. Up to \$50,000 of used property can be taken into account in any year.

Property with a useful life of from four to six years qualifies for the credit to the extent of one-third of its cost. Property with a useful life of six to eight years, qualifies to the extent of two-thirds of the investment. If the property has a useful life of eight years or more, the full amount qualifies.

The amount of the investment credit taken in any year may not exceed the first \$25,000 of tax liability plus 50 percent of the tax liability in excess of \$25,000. Investment credits which, because of this limitation, cannot be used in the current year may be carried back to the three prior years and carried forward to the succeeding 7 taxable years.

*Problem.*—The investment credit does not appear to be suited to present conditions. The credit was designed to provide a tax inducement for businessmen to modernize their equipment and expand productive capacity. Since 1962, business has invested almost \$400 billion in new plant and equipment, and it would appear that there is no reason to grant a tax inducement for new investment now.

The current outlook is that plant and equipment expenditures will reach record levels in 1969. The most recent Commerce Department—SEC survey indicates that such expenditures will reach \$72.2 billion in 1969—12.5 percent more than was spent for this purpose in 1968. Much of this investment results from the present inflationary psychology which induces businessmen to increase plant and equipment spending beyond normal levels in an attempt to avoid higher costs in later years.

In such a situation, business investment should not be stimulated. Instead, such investment should be moderated in order to contain an overactive economy and reduce inflationary pressures.

The investment credit cannot be turned on and off quickly to adjust to current economic conditions. In 1966, the credit was suspended temporarily in order to reduce the inflationary impact of large investment expenditures; but the investment credit continued to have an expansionary impact on some investments beyond the cutoff date as a result of transition provisions and carryovers of unused credits. In other cases, there was distortion in the investment process because businessmen postponed normal investments in anticipation of the time when the credit would be restored.

*House solution.*—The House bill provides for the permanent repeal of the investment credit in the case of property acquired, or the construction of which is begun, after April 18, 1969. The bill also provides an exception to this general rule under which the credit is to continue to be available for property constructed or acquired under a binding contract entered into before April 19, 1969. A number of other transition rules are also provided by the bill under which the credit will continue to be available in situations where, although a binding contract is not involved, a substantial portion of the property in question had been acquired, constructed, or contracted for prior to April 19, 1969. The transition rules in the bill are generally the same as those provided in the legislation which temporarily suspended the investment credit in 1966.

The bill also provides for the “phaseout” of the investment credit in the case of property placed in service after 1970 (which generally would be eligible for the credit under a transition rule). Under this “phaseout,” the credit is to be reduced by one-tenth of one percentage point for each full calendar month after November 1970 and the date the property is placed in service. In addition, no credit will be allowable for property placed in service after 1974.

The bill also places a limit on the extent to which taxpayers may carry over unused investment credits to 1969 and subsequent years. As of the end of 1968 these unused investment credits amounted to an estimated \$2 billion. Under the limitation provided by the bill, the credit taken in a year after 1968, attributable to carryovers, cannot exceed 20 percent of the aggregate amount of unused investment credits otherwise available as carryovers to the year in question (or to any prior year after 1968 if the carryovers to that year are higher than in the current year). This limitation is in addition to the general 50 percent of the tax liability limitation on the amount of credit which may be claimed in a year. The bill also retains the present length of the carryover periods (3 years back and 7 years forward).

*Note.*—This provision was included in H.R. 12290, the bill to repeal the 7 percent investment tax credit, to extend the 10 percent income tax surcharge, and for other purposes. It was approved by the Committee on Finance when the Committee ordered that bill reported in July. For that reason no position for or against it is stated.

#### **4. Amortization of Pollution Control Facilities**

*Present law.*—Under present law, a taxpayer may claim an investment credit with respect to pollution control facilities to the extent

they involve property of a type generally eligible for the investment credit.

*Problem.*—There is a present need for industry to install facilities that will remove pollutants and contaminants from air and water discharged after use in production processes. Since termination of the investment credit will remove to some extent the financial offsets to the costs of these facilities, an alternative form of incentive may be viewed as desirable.

*House solution.*—The bill provides that a taxpayer will be allowed to amortize over a period of 60 months any new certified air or water pollution control facility that is identifiable as a separate treatment facility. The amortization deduction would be taken in place of the regular depreciation deduction. The amortization deduction generally would be available only for a pollution control facility that is constructed after 1965 and that is certified by the appropriate State and Federal Authorities as being in conformity with relevant programs and requirements for the abatement or control of air or water pollution. The amortization is to be available for taxable years ending after 1968.

*Note.*—This provision was included in H.R. 12290, the bill to repeal the 7 percent investment tax credit, to extend the 10 percent income tax surcharge, and for other purposes. It was approved by the Committee on Finance when the Committee ordered that bill reported in July. For that reason no position for or against it is stated.

## 5. Amortization of Certain Railroad Rolling Stock

*Present law.*—A taxpayer may claim an investment credit with respect to railroad rolling stock to the extent they are property of a type for which the investment credit generally is available. Under present depreciation guidelines, the useful life of rolling stock is 14 years.

*Problem.*—The railroad industry generally has been in poor financial condition for many years. The investment credit made a substantial contribution to the modernization of railroad equipment and in increasing railroad efficiency by improving the ability of the railroads to finance the acquisition of new equipment.

*House solution.*—Domestic common carrier railroads subject to regulation by the Interstate Commerce Commission may elect to amortize all railroad rolling stock (except locomotives) over a period of 84 months. (The bill erroneously provides for 7-year depreciation, instead of amortization). The provision applies to eligible rolling stock that is constructed or acquired and put into original use after July 31, 1969.

*Arguments For.*—(1) Amortization is an appropriate incentive because it permits a rapid recovery of the costs involved and does not extend a return in excess of actual total costs.

(2) Amortization is preferable to accelerated depreciation because it permits a complete write-off of the equipment without adjustment for salvage value.

(3) Amortization is preferable to depreciation because it does not entail adjustment for the restrictions required by the "reserve ratio test" in the depreciation guidelines.

(4) On the other hand, the amortization provision does not extend to companies which purchased railroad rolling stock eligible for the investment credit and leased the equipment to railroads.

(5) Since it appears the 7-percent investment tax credit will be repealed without industry exemptions, some other form of stimulus—such as amortization—must replace it or the railroads will be unable to attract capital needed to modernize and expand their rolling stock.

*Arguments Against.*—(1) Repealing the 7-percent investment tax credit and replacing it with amortization is just substituting one tax preference for another.

(2) If there is freight to be hauled, the profit motive is all the incentive needed to assure that the necessary rolling stock will be acquired.

(3) The depreciation practices of the railroad industry are already among the most complex of any industry, and this provision compounds the complexity without adding greatly to the cash flow they presently can generate through accelerated depreciation.

## AA. ADJUSTMENT OF TAX BURDEN FOR INDIVIDUALS

### 1. Increase in Standard Deduction

*Present law.*—Under present law, a taxpayer in computing taxable income may itemize his deductions, or may take the larger of the minimum standard deduction or the 10 percent standard deduction. The minimum standard deduction is \$200 plus \$100 for each exemption, and the regular standard deduction is 10 percent of adjusted gross income. Both forms of the standard deduction are limited to \$1,000 (\$500 in the case of a married individual filing a separate return).

*Problem.*—The 10 percent standard deduction was introduced in 1944 to reduce the complexity of the income tax for the vast majority of taxpayers. Instead of keeping records of deductible personal expenditures and itemizing deductions on their tax returns more than 82 percent of taxpayers were able to use the simpler standard deduction when it was first introduced. Since that time, higher medical costs, higher interest rates, higher State and local taxes, increased homeownership, and more expensive homes have encouraged more and more taxpayers to itemize their deductions. In addition, itemization has been encouraged by rising incomes which have moved more and more taxpayers beyond the \$10,000 income level where the \$1,000 standard deduction ceiling first becomes applicable. The effect of higher incomes and increased expenses has been to decrease the proportion of returns using the standard deduction from 82 to 58 percent.

*House solution.*—The House bill increases the 10-percent standard deduction and \$1,000 ceiling to 15 percent with a \$2,000 ceiling in three stages: in 1970 to 13 percent with a \$1,400 ceiling, in 1971 to 14 percent with a \$1,700 ceiling, and in 1972 to 15 percent with a \$2,000 ceiling. The increase was made in three stages to avoid an excessive revenue loss in 1970 and 1971.

*Arguments For.*—(1) The 15-percent standard deduction with a \$2,000 ceiling will result in substantial simplification. This combined with the \$1,100 low-income allowance also contained in the bill will cause a total of 11.8 million or 37 percent of all itemizers to

switch to the standard deduction. The proportion of returns using the standard deduction as a result of the low-income allowance and the higher standard deduction taken together will be nearly 74 percent.

(2) This higher standard deduction also will provide a tax reduction to a substantial number of taxpayers. By itself, the 15 percent, with a \$2,000 ceiling will reduce taxes by \$2.4 billion for 33.7 million returns or more than 53 percent of taxable returns. After the low-income allowance of \$1,100, it will provide a tax reduction of \$1.4 billion for approximately 16.7 million returns or 29 percent of the returns which remain taxable after the low-income allowance.

(3) In 1944, when the standard deduction was first added to the tax law, 82.2% of the individual tax returns filed used the standard deduction in lieu of itemizing. However, by 1965 only 58.8% of the returns filed used this deduction. The bill will help to restore the use of the standard deduction to the 1944 levels.

(4) The provision will reduce the number of income tax returns which will need to be audited by the Internal Revenue Service.

*Arguments Against.*—(1) If the standard deduction is liberalized, tax incentives for making contributions to charity will be reduced for many taxpayers.

(2) The standard deduction permits two taxpayers, in the same family circumstances and with the same adjusted gross income, to pay the same tax even though these two taxpayers incur substantially different amounts of itemizable expenses. Raising the standard deduction will, of course, increase this inequity.

(3) Other provisions of the bill provide rate reductions to all individual taxpayers. The increase in the amount of the standard deduction will, in effect, provide additional reduction of tax liability to many of the same individuals and amounts to a doubling of tax benefits.

(4) The 15-percent standard deduction with a \$2,000 ceiling involves too great a revenue loss. Furthermore, it is noted that the doubling of the ceiling (from \$1,000 to \$2,000) provides larger percentage tax decreases to taxpayers in the \$10,000 to \$15,000 income range than to any other group.

## 2. Low-Income Allowance

*Present law.*—The minimum standard deduction is \$200 plus \$100 for each personal exemption up to a total of \$1,000.

*Problem.*—Inflationary price increases have had their most severe impact in the erosion of the already inadequate purchasing power of the poor. In addition, recent studies of the economic conditions of the poor by the Department of Health, Education, and Welfare have indicated, even with the present minimum standard deduction, many persons with incomes below the poverty level are subject to tax and, in addition, substantial tax burdens are imposed on those with incomes immediately above the poverty levels.

*House solution.*—The bill replaces the minimum standard deduction with a low income allowance of \$1,100 for each taxpayer. The level of taxation for each taxpayer, thus, will begin where adjusted gross income exceeds the \$1,100 low income allowance plus the number of personal exemptions the taxpayer may claim. The low income allowance will be available for 1970 and later years.

In 1970 only, the bill provides a phaseout of the low income allowance (to the extent it exceeds the present minimum standard deduction). This excess is to be reduced by \$1 for each \$2 that the taxpayer's adjusted gross income exceeds the nontaxable income level. The phaseout is repealed after calendar year 1970.

*Note.*—This provision was included in H.R. 12290, the bill to repeal the 7 percent investment tax credit, to extend the 10 percent income tax surcharge, and for other purposes. It was approved by the Committee on Finance when the Committee ordered that bill reported in July. For that reason no position for or against it is stated.

However it is observed that the phaseout of the low-income allowance is deleted with respect to years after 1970, raising the cost of the allowance by \$2 billion.

### 3. Maximum Tax on Earned Income

*Present law.*—Under present law, the individual income tax rates reach a maximum of 70 percent for taxable income in excess of \$100,000 for single persons and \$200,000 for joint returns. The 70 percent rate is applicable to all taxable income other than capital gains subject to the alternative rate of 25 percent.

*Problem.*—The present tax rates with a maximum of 70 percent seem unrealistically high especially in the case of earned income. They appear to have some disincentive effect and motivate taxpayers to use and develop methods of tax avoidance. The high rates are, in part, responsible for attempts to shelter income from tax and for the diversion of considerable time, talent, and effort into "tax planning" rather than economically productive activities. The high rates also take what can be considered an excessive portion of the income of those who are unable to shelter their earned income from the full impact of these rates.

*House solution.*—The House-passed bill provides that the maximum marginal tax rate applicable to an individual's earned income is not to exceed 50 percent. This is, in effect, an alternative tax computation for earned income under which earned income in the taxable income brackets where the tax rate would otherwise be greater than 50 percent is subject to a flat 50 percent rate.

*Argument For.*—(1) While it is not feasible to reduce the tax rates in excess of 50 percent to 50 percent for all types of income at the present time because of the revenue cost, a reduction in the tax rates applicable to earned income to a maximum of 50 percent should substantially reduce the pressure to use and develop tax loopholes. Since the disincentive effect of high tax rates on effort is greatest in the case of earnings, it is most efficient to focus the 50 percent limit on earned income.

(2) High tax rates on *earned* income (wages, salaries, and fees) reduces personal initiative because the high bracket taxpayer receives only a small marginal amount of "after tax" income for any additional work.

*Arguments Against.*—(1) This provision is a "loophole for those persons without loopholes." The income tax base should be broadened with the rates on that tax base made substantially lower.

(2) There is no reason for lowering the tax rate if the "ability to pay" theory of a progressively graduated income tax structure is accepted.

(3) The main objection to the maximum rate of 50 percent on earned income is that it limits the top rate of 50 percent to one type of income instead of making rate reduction generally applicable. For example, instead of a 65 percent top rate for unearned income and a 50 percent top rate for earned income it might be argued that it would be preferable to make the top rate 60 percent for all types of income.

#### 4. Intermediate Tax Rates: Surviving Spouse Treatment

*Present law.*—Since the Revenue Act of 1948, married couples filing joint returns have had the option of being taxed under the split-income provision. This, in effect, taxes a married couple as if it were composed of two single individuals each with one-half the couple's combined income. This 50-50 split of income between the spouses for tax purposes generally produces a lower tax than any other division of income since the application of the graduated tax rates separately to each of the two equal parts comprising the couple's income keeps the total income in lower tax brackets.

Single people generally do not have a comparable income splitting privilege. As a result they pay higher taxes than married couples at the same income levels.

In 1951, a head-of-household provision was enacted to grant partial income-splitting to widows, widowers, and single persons with dependents in their households. Individuals who qualify under this provision are allowed approximately one-half of the income-splitting benefits given to married couples. These heads of household use a different tax rate schedule which, at any given level of income, produces a tax liability about halfway between the tax paid by a married couple filing a joint return and a single individual.

Beginning in 1954 surviving spouses with dependent children were permitted to use the joint return tax rates with full income splitting for two taxable years following the year of death of the husband or wife.

*Problem.*—Widows, widowers, and unmarried individuals who do not support dependents in a household cannot qualify for head-of-household treatment under present law. As a result, such individuals are taxed as single individuals and do not receive the income-splitting benefits accorded to heads of households (that is, one-half the income-splitting benefits granted to married couples filing joint returns). It is argued that this treatment places unduly heavy tax burdens on mature single individuals, widows and widowers. Such individuals more often than not have to incur the expense of maintaining a household; and in any event, it is maintained, they should receive some income splitting in order to be treated fairly compared with married couples. Moreover, for widows and widowers present law is said to be harsh in that it withdraws all the benefits of income splitting after their spouse dies despite the fact that they may continue to have relatively heavy living expenses.

*House solution.*—The House bill extends the benefits of income splitting to specified groups of individuals whose taxes are deemed to be too heavy under present law.

Under the bill, widows and widowers, regardless of age, and unmarried individuals age 35 and over are to be taxed at rates which are halfway between the rates available to married couples and those previously available to single persons. This intermediate tax rate treatment was formerly known as head-of-household treatment. This provision applies to years beginning after 1970.

The bill also provides that a widow, or widower, with a dependent child in the household is to receive the full income splitting benefits available to married couples for as long as she or he continues to support the child in her or his household and is entitled to a dependency exemption for the child (rather than just two years after the person's spouse has died as at present). Generally, this treatment will be available where the child is age 19 or less or is attending school or college. This provision applies to years beginning after 1969.

*Arguments For.*—(1) The House provision extends relief to large numbers of mature single individuals and surviving spouses whose taxes are now relatively heavy compared with those paid by married couples at the same income levels. This is favored by those who generally believe that the split-income provision grants excessive tax reductions to married couples and places too heavy burdens on single people generally.

(2) Surviving spouses with a dependent child continue to have the full obligations of a married couple toward their children after their spouses die. Therefore, they should continue to receive full income-splitting.

*Arguments Against.*—(1) The selection of age 35 as the age at which individuals should receive a more favorable tax treatment is arbitrary. Many single individuals, of that age or older, with considerably different economic situations will be receiving the same tax treatment while those of slightly different ages but similar incomes will be taxed differently.

(2) A more favorable result for the Treasury—but one producing equity for single persons—would be reached if income splitting for married taxpayers were repealed instead of extending split income tax relief to certain single individuals.

(3) The provision is adverse to marriage because two individuals eligible for the intermediate tax rates (which confer one-half the full income-splitting benefits accorded married couples) could find their combined tax liabilities increased as a result of marriage. However, there is some question whether marriage is significantly affected by such tax considerations.

## 5. Individual Income Tax Rates

*Present law.*—Present law tax rates range from 14 percent to 70 percent on taxable income in excess of \$100,000 for a single taxpayer and \$200,00 for a joint return (see the rate schedule, p. 105).

*Problem.*—The present tax rates are considered by many to be too high. They take an excessive portion of the income from those subject to the full impact of the rates. Such high rates also encourage many taxpayers to shelter their income from the top rates by using tax avoidance techniques which have frequently developed into tax loopholes.

*House solution.*—The House bill reduces all tax rates by at least one percentage point and reduces the top bracket rate from 70 percent to 65 percent. In all brackets this is a tax reduction of 5 percent or more. The reduction is to take place in two stages because of the



revenue loss: half in 1971, and the full reduction in 1972. (See the rate schedule below).

INDIVIDUAL INCOME TAX RATE SCHEDULE UNDER PRESENT LAW AND UNDER H.R. 13270 FOR CALENDAR YEARS 1971 AND 1972

Taxable income bracket		Tax rate (percent)		
Single person not eligible for intermediate rates	Married (Joint)	Present law	House bill	
			1971	1972
\$000 to \$500.....	\$000 to \$1,000.....	14	13.5	13
\$500 to \$1,000.....	\$1,000 to \$2,000.....	15	14.5	14
\$1,000 to \$1,500.....	\$2,000 to \$3,000.....	16	15.5	15
\$1,500 to \$2,000.....	\$3,000 to \$4,000.....	17	16.5	16
\$2,000 to \$4,000.....	\$4,000 to \$8,000.....	19	18.5	18
\$4,000 to \$5,000.....	\$8,000 to \$12,000.....	22	21.5	21
\$5,000 to \$8,000.....	\$12,000 to \$16,000.....	25	24	23
\$8,000 to \$10,000.....	\$16,000 to \$20,000.....	28	27.5	27
\$10,000 to \$12,000.....	\$20,000 to \$24,000.....	32	31	30
\$12,000 to \$14,000.....	\$24,000 to \$28,000.....	36	35	34
\$14,000 to \$16,000.....	\$28,000 to \$32,000.....	39	38	37
\$16,000 to \$18,000.....	\$32,000 to \$36,000.....	42	41	40
\$18,000 to \$20,000.....	\$36,000 to \$40,000.....	45	43.5	42
\$20,000 to \$22,000.....	\$40,000 to \$44,000.....	48	46	44
\$22,000 to \$26,000.....	\$44,000 to \$52,000.....	50	48.5	47
\$26,000 to \$32,000.....	\$52,000 to \$64,000.....	53	51	49
\$32,000 to \$38,000.....	\$64,000 to \$76,000.....	55	52.5	50
\$38,000 to \$44,000.....	\$76,000 to \$88,000.....	58	55	52
\$44,000 to \$50,000.....	\$88,000 to \$100,000.....	60	57	54
\$50,000 to \$60,000.....	\$100,000 to \$120,000.....	62	60	58
\$60,000 to \$70,000.....	\$120,000 to \$140,000.....	64	62	60
\$70,000 to \$80,000.....	\$140,000 to \$160,000.....	66	63	60
\$80,000 to \$90,000.....	\$160,000 to \$180,000.....	68	64.5	61
\$90,000 to \$100,000.....	\$180,000 to \$200,000.....	69	65	61
\$100,000 to \$120,000.....	\$200,000 to \$240,000.....	70	66	62
\$120,000 to \$150,000.....	\$240,000 to \$300,000.....	70	66.5	63
\$150,000 to \$200,000.....	\$300,000 to \$400,000.....	70	67	64
\$200,000 and over.....	\$400,000 and over.....	70	67.5	65

*Arguments For.*—(1) It is appropriate to redistribute the tax burden by closing loopholes and eliminating preferences on the one hand, and lowering tax rates on the other.

(2) Tax reduction is justified on the grounds that present rates are unrealistic and have been instrumental in encouraging the development of tax avoidance devices and tax shelters. Lower tax rates reduce the incentive to use and devise methods of avoiding tax and reduce the disproportionate influence of tax considerations on economic decisions, both socially desirable goals.

*Arguments Against.*—(1) Tax rates should not be reduced (even on a prospective basis) during a period when inflation is so strong, and further extension of the income tax surcharge is being considered to combat it.

(2) One objection to the reduction of all tax rates is that the revenue cost is \$4.5 billion. This amount unbalances the reform and relief program in contrast to the rate schedule in the bill as reported by the Ways and Means Committee. That rate schedule roughly balanced the revenue gain from tax reform and the revenue loss from tax relief.

## 6. Collection of Income Tax at Source on Wages

*Present law.*—Present law provides withholding tables and a percentage withholding method which incorporates the \$600 personal exemption, the minimum standard deduction, the 10 percent standard deduction, and the tax rates.

*House solution.*—The withholding rates and tables incorporate the changes made in the minimum standard deduction (the low income allowance), the 10 percent standard deduction, and the tax rates.



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**PART 3**  
**STATISTICAL MATERIAL—TABLES**

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## PART 3

### STATISTICAL MATERIAL—TABLES

TABLE 1.—THE BALANCING OF TAX REFORM WITH TAX RELIEF UNDER H.R. 13270 WITH MODIFIED  
RATE REDUCTION—CALENDAR YEAR TAX LIABILITY

[In millions of dollars]

	1970	1971	1972	1974	1979
Tax reform program.....	+1,640	+2,050	+2,180	+2,600	+3,555
Repeal of investment credit.....	+2,500	+3,000	+3,000	+3,100	+3,300
Tax reform and repeal of investment credit.....	+4,140	+5,050	+5,180	+5,700	+6,855
Income tax relief.....	-1,692	-6,787	-9,273	-9,273	-9,273

Note: The tax surcharge extension (\$3,100,000,000 liability for 1970) and the excise tax extension (\$1,170,000,000<sup>1</sup> \$800,000,000, \$800,000,000, and \$400,000,000 for 1970 through 1973, respectively) are not included above because of their impermanent character.

TABLE 2.—BALANCING OF TAX REFORM AND TAX RELIEF—CALENDAR YEAR TAX LIABILITY

[In millions of dollars]

	1970	1971	1972	1974	1979
Tax reform program.....	+1,640	+2,050	+2,180	+2,600	+3,555
Repeal of investment credit.....	+2,500	+3,000	+3,000	+3,100	+3,300
Tax reform and repeal of investment credit.....	+4,140	+5,050	+5,180	+5,700	+6,855
Income tax relief:					
Low income allowance.....	-625	-625	-625	-625	-625
Removal of phaseout on low income allowance.....	-2,027	-2,027	-2,027	-2,027	-2,027
Increase in standard deduction <sup>1</sup> .....	-867	-1,086	-1,373	-1,373	-1,373
Rate reduction.....	-2,249	-2,249	-4,498	-4,498	-4,498
Maximum 50-percent rate on earned income.....	-200	-150	-100	-100	-100
Intermediate tax treatment for certain single persons, etc.....		-650	-650	-650	-650
Total reductions.....	-1,692	-6,787	-9,273	-9,273	-9,273

<sup>1</sup> 1970: 13 percent, \$1,400 ceiling; 1971: 14 percent, \$1,700 ceiling; 1972: 15 percent, \$2,000 ceiling.

Note: The tax surcharge extension (\$3,100,000,000 liability for 1970) and the excise tax extension (\$1,170,000,000, \$800,000,000, \$800,000,000 and \$400,000,000, for 1970 through 1973, respectively) are not included above because of their impermanent character.

TABLE 3.—INDIVIDUAL INCOME TAX LIABILITY—TAX UNDER PRESENT LAW AND AMOUNT AND PERCENTAGE OF CHANGE UNDER REFORM AND RELIEF PROVISIONS WHEN FULLY EFFECTIVE

AGI class	Tax under present law (millions)	Increase (+) decrease (—), from reform and relief provisions (taking into account committee amendment)		Percentage tax decrease under original rate schedule	Additional percentage point reduction from modified rate schedule
		Amount (millions)	Percentage		
\$0 to \$3,000.....	\$1,169	—\$775	—66.3	—64.0	2.3
\$3,000 to \$5,000.....	3,320	—1,049	—31.6	—27.3	4.3
\$5,000 to \$7,000.....	5,591	—996	—17.8	—12.3	5.5
\$7,000 to \$10,000.....	11,792	—1,349	—11.4	—6.5	4.9
\$10,000 to \$15,000.....	18,494	—1,932	—10.4	—6.0	4.4
\$15,000 to \$20,000.....	9,184	—775	—8.4	—5.4	3.0
\$20,000 to \$50,000.....	13,988	—976	—7.0	—5.1	1.9
\$50,000 to \$100,000.....	6,659	—365	—5.5	—5.0	.5
\$100,000 and over.....	7,686	+324	+4.2	+4.2	.....
Total.....	77,884	—7,893	—10.1	—7.0	3.1

TABLE 4.—TAX RELIEF PROVISIONS AFFECTING INDIVIDUALS AND TOTAL FOR ALL REFORM AND RELIEF PROVISIONS AFFECTING INDIVIDUALS, WHEN FULLY EFFECTIVE, BY ADJUSTED GROSS INCOME CLASS, 1969 LEVELS

(In millions of dollars)

AGI class	Reform provisions	Low income allowance	Elimination of phaseout	15-percent \$2,000 standard deduction	General rate reductions	Maximum tax on earned income	Intermediate tax treatment	Total relief provisions	Total, all provisions
0 to \$3,000.....	+16	—552	—202	.....	—27	.....	—10	—791	—775
\$3,000 to \$5,000.....	—3	—72	—788	.....	—141	.....	—45	—1,046	—1,049
\$5,000 to \$7,000.....	+3	—1	—594	.....	—329	.....	—75	—999	—996
\$7,000 to \$10,000.....	+7	.....	—335	—228	—663	.....	—130	—1,356	—1,349
\$10,000 to \$15,000.....	+26	.....	—83	—789	—975	.....	—111	—1,958	—1,932
\$15,000 to \$20,000.....	+23	.....	—16	—231	—496	.....	—55	—798	—775
\$20,000 to \$50,000.....	+90	.....	—8	—117	—806	.....	—135	—1,066	—976
\$50,000 to \$100,000.....	+137	.....	—1	—7	—420	—20	—54	—502	—365
\$100,000 and over....	+1,081	.....	.....	—1	—641	—80	—35	—757	+324
Total.....	+1,380	—625	—2,027	—1,373	—4,498	—100	—650	—9,273	—7,893

TABLE 5.—TAX REFORM PROVISIONS AFFECTING INDIVIDUALS, FULL YEAR EFFECT—BY ADJUSTED GROSS INCOME CLASS

[In millions of dollars]

Adjusted gross income class (thousands)	Eliminate alternative tax rate <sup>1</sup> on long- term gains	6- to 12- month gains included at 100 percent <sup>1</sup>	Capital loss limi- ta- tion	Pension plan pro- v- i- sion	Life es- ta- tes pro- v- i- sion	Averaging capital gains and losses 120 percent	Deferred compen- sa- tion	Char- itable de- duc- tions	Inter- est de- duc- tion	Reduce per- cent depre- cia- tion	Accu- mula- tion trust pen- sions	Mov- ing ex- penses	Farm losses	Real estate	Tax- free divi- dends	Lim- ited tax prefer- ence	Alloca- tion	Total
0 to \$3.....	.....	+ \$1	+ \$5	(?)	.....	(?)	(?)	.....	.....	+ \$1	(?)	- \$1	.....	(?)	(?)	+ \$10	(?)	+ \$16
\$3 to \$5.....	.....	+ 2	+ 3	+ \$1	.....	(?)	(?)	.....	.....	+ 1	(?)	- 11	.....	(?)	(?)	+ 1	(?)	- 3
\$5 to \$7.....	.....	+ 2	+ 5	+ 2	.....	(?)	(?)	.....	.....	+ 2	+ 1	- 13	.....	(?)	(?)	+ 3	(?)	- 7
\$7 to \$10.....	.....	+ 5	+ 9	+ 3	.....	(?)	(?)	.....	.....	+ 2	+ 3	- 23	.....	+ \$5	(?)	+ 2	(?)	+ 26
\$10 to \$15.....	.....	+ 10	+ 15	+ 9	.....	- \$5	(?)	.....	.....	+ 5	+ 3	- 29	.....	+ 10	(?)	+ 3	(?)	+ 23
\$15 to \$20.....	.....	+ 10	+ 8	+ 6	.....	- 30	(?)	.....	.....	+ 5	+ 3	- 10	.....	+ 10	(?)	+ 3	(?)	+ 30
\$20 to \$50.....	+ \$1	+ 35	+ 16	+ 17	(?)	- 110	(?)	.....	.....	+ 19	+ 16	- 11	.....	+ 45	(?)	+ 10	(?)	+ 85
\$50 to \$100.....	+ 11	+ 30	+ 4	+ 10	+ \$5	- 105	+ \$20	.....	.....	+ 13	+ 17	- 2	+ \$5	+ 50	+ 19	+ 10	(?)	+ 137
\$100 and over.....	+ 348	+ 55	(?)	+ 22	+ 5	- 50	+ 5	+ \$20	+ \$20	+ 22	+ 29	(?)	+ 20	+ 140	+ 35	+ 30	+ 365	+ 1,081
Total.....	+ 360	+ 150	+ 65	+ 70	+ 10	- 300	+ 25	+ 20	+ 20	+ 70	+ 70	- 100	+ 25	+ 260	+ 80	+ 85	+ 470	+ 1,380

<sup>1</sup> Assumes 1/2 of effect as compared with no change in realization.<sup>2</sup> Less than \$500,000.

TABLE 6.—REVENUE ESTIMATES, TAX REFORM, CALENDAR YEAR LIABILITY<sup>1</sup>

[In millions of dollars]

	1970	1971	1972	1974	1979
Corporate capital gains.....	175	175	175	75	175
Foundations—Investment income tax.....	65	70	75	85	100
Unrelated business income.....	5	5	5	5	20
Contributions.....	5	10	20	20	20
Farm losses.....	(2)	5	10	10	20
Moving expenses.....	-100	-100	-100	-100	-100
Railroad depreciation.....	(2)	-5	-20	-70	-100
Amortization of air and water pollution.....	-40	-130	-230	-380	-400
Corporate mergers, etc.....	10	20	25	40	70
Multiple corporations.....	20	45	75	135	235
Accumulation trusts.....	50	70	70	70	70
Income averaging.....	-300	-300	-300	-300	-300
Deferred compensations:					
Restricted stock.....	(2)	(2)	(2)	(2)	(2)
Other deferred compensation.....	(2)	(2)	5	10	25
Stock dividends.....	(2)	(2)	(2)	(2)	(2)
Subchapter S.....	(2)	(2)	(2)	(2)	(2)
Tax-free dividends.....				80	80
Financial institutions:					
Commercial banks:					
Reserve.....	250	250	250	250	250
Capital gain.....	50	50	50	50	50
Mutual thrift:					
Reserve—savings and loan associations.....	10	25	35	60	125
Mutual.....	(2)	5	10	15	35
Municipals.....	(2)	(2)	(2)	(2)	(2)
Capital gains:					
Capital loss provisions.....	50	50	55	60	65
6 months-1 year holding.....	100	150	150	150	150
Pension plans.....	(2)	5	10	25	50
Casualty loss.....	(2)	(2)	(2)	(2)	(2)
Sale of papers.....	(2)	(2)	(2)	(2)	(2)
Life estates.....	10	10	10	10	10
Franchises.....	(2)	(2)	(2)	(2)	(2)
Removal of alternate rate.....	360	360	360	360	360
Natural resources:					
Production payment.....	100	110	125	150	200
Cut percentage depletion.....	400	400	400	400	400
Foreign depletion <sup>3</sup> .....	25	10	(2)	(2)	(2)
Foreign income:					
Loss carryover.....	35	35	35	35	35
Restriction on mineral credits.....	30	30	30	30	30
Individual interest deduction.....	20	20	20	20	20
Regulated utilities <sup>4,5</sup> .....	60	140	185	260	310
Cooperatives.....	(2)	(2)	(2)	(2)	(2)
Limit on tax preferences (LPT).....	40	50	60	70	85
Allocation.....	205	420	425	440	460
Real estate:					
Used property.....	15	40	65	150	250
New nonhousing.....	(2)	60	170	435	960
Capital gain, recapture.....	5	15	25	50	125
Rehabilitation.....	-15	-50	-100	-200	-330
Preliminary total.....	1,640	2,050	2,180	2,600	3,555
Plus investment credit.....	2,500	3,000	3,000	3,100	3,300
Total.....	4,140	5,050	5,180	5,700	6,855

<sup>1</sup> Except as indicated these estimates are all at current levels, the time differences being solely to show the phase-in.<sup>2</sup> Less than \$2,500,000.<sup>3</sup> Potentially, a larger gain appears possible. The figure shown assumes this will be offset in the beginning by carryovers of unused credits and in the later years by increased foreign taxes.<sup>4</sup> Assumes growth.<sup>5</sup> Excludes change to 150 percent for construction of public utilities, 1971, \$10,000,000; 1972, \$30,000,000; 1974, \$50,000,000; and 1979, \$80,000,000.



TABLE 7.—TAXABLE RETURNS UNDER PRESENT LAW, NUMBER MADE NONTAXABLE BY RELIEF PROVISIONS AND NUMBER BENEFITING FROM RATE REDUCTION

[Number of returns in thousands]

AGI class	Taxable under present law	Made nontaxable by low-income allowance and 15 percent \$2,000 standard deduction	Remaining taxable—benefit from modified rate reduction
0 to \$3,000.....	10,053	5,398	4,655
\$3,000 to \$5,000.....	9,562	389	9,173
\$5,000 to \$7,000.....	9,779	41	9,738
\$7,000 to \$10,000.....	13,815	8	13,807
\$10,000 to \$15,000.....	13,062	7	13,055
\$15,000 to \$20,000.....	3,852	2	3,850
\$20,000 to \$50,000.....	2,594	-----	2,594
\$50,000 to \$100,000.....	340	-----	340
\$100,000 and over.....	95	-----	95
Total.....	63,152	5,845	57,307

TABLE 8.—TAX BURDENS UNDER PRESENT LAW,<sup>1</sup> UNDER H.R. 13270,<sup>2</sup> AND PERCENT TAX CHANGE (ASSUMES NONBUSINESS DEDUCTIONS OF 10 PERCENT OF INCOME)

Adjusted gross income (wages and salaries)	Married couple with 2 dependents			Adjusted gross income (wages and salaries)	Married couple with 2 dependents		
	Present tax law	H.R. 13270 tax	Percent tax change		Present tax law	H.R. 13270 tax	Percent tax change
\$3,000.....	<sup>3</sup> 0	<sup>4</sup> 0	0	\$12,500.....	<sup>5</sup> \$1,567	<sup>6</sup> \$1,347	-14.0
\$3,500.....	<sup>3</sup> \$70	<sup>4</sup> 0	-100.0	\$15,000.....	<sup>5</sup> 2,062	<sup>7</sup> 1,846	-10.5
\$4,000.....	<sup>3</sup> 140	<sup>4</sup> \$65	-53.6	\$17,000.....	<sup>5</sup> 2,598	<sup>7</sup> 2,393	-7.9
\$5,000.....	<sup>3</sup> 290	<sup>4</sup> 200	-31.0	\$20,000.....	<sup>5</sup> 3,160	<sup>7</sup> 2,968	-6.1
\$7,500.....	<sup>5</sup> 687	<sup>6</sup> 576	-16.2	\$25,000.....	<sup>5</sup> 4,412	<sup>6</sup> 4,170	-5.5
\$10,000.....	<sup>5</sup> 1,114	<sup>6</sup> 958	-14.0				

<sup>1</sup> Does not include 10-percent surcharge.<sup>2</sup> Uses provisions effective for tax year 1972.<sup>3</sup> Uses minimum standard deduction of \$600.<sup>4</sup> Uses minimum standard deduction of \$1,100.<sup>5</sup> Itemizes deductible nonbusiness expenses.<sup>6</sup> Uses 15-percent standard deduction.<sup>7</sup> Uses \$2,000 limit on 15-percent standard deduction.TABLE 9.—TAX BURDENS UNDER PRESENT LAW,<sup>1</sup> UNDER H.R. 13270,<sup>2</sup> AND PERCENT TAX CHANGE (ASSUMES NONBUSINESS DEDUCTIONS OF 10 PERCENT OF INCOME)

Adjusted gross income (wages and salaries)	Single person under 35 (not a widow or widower)			Adjusted gross income (wages and salaries)	Single person under 35 (not a widow or widower)		
	Present tax law	H.R. 13270 tax	Percent tax change		Present tax law	H.R. 13270 tax	Percent tax change
\$900.....	<sup>3</sup> 0	<sup>4</sup> 0	0	\$10,000.....	<sup>5</sup> \$1,742	<sup>6</sup> \$1,507	-13.5
\$1,700.....	<sup>3</sup> \$115	<sup>4</sup> 0	-100.0	\$12,500.....	<sup>5</sup> 2,398	<sup>6</sup> 2,078	-13.3
\$3,000.....	<sup>3</sup> 329	<sup>4</sup> \$180	-45.3	\$15,000.....	<sup>5</sup> 3,154	<sup>6</sup> 2,806	-11.0
\$4,000.....	<sup>3</sup> 500	<sup>4</sup> 344	-31.2	\$17,500.....	<sup>5</sup> 3,999	<sup>6</sup> 3,683	-7.9
\$5,000.....	<sup>5</sup> 671	<sup>4</sup> 524	-21.9	\$20,000.....	<sup>5</sup> 4,918	<sup>6</sup> 4,650	-5.4
\$7,500.....	<sup>5</sup> 1,168	<sup>6</sup> 1,023	-12.4	\$25,000.....	<sup>5</sup> 6,982	<sup>6</sup> 6,566	-6.0

<sup>1</sup> Does not include 10-percent surcharge.<sup>2</sup> Uses provisions effective for tax year 1972.<sup>3</sup> Uses minimum standard deduction of \$300.<sup>4</sup> Uses minimum standard deduction of \$1,100.<sup>5</sup> Uses 10-percent standard deduction.<sup>6</sup> Uses 15-percent standard deduction.<sup>7</sup> Itemizes deductible nonbusiness expenses.<sup>8</sup> Uses \$2,000 limit on 15-percent standard deduction.

TABLE 10.—TAX BURDENS UNDER PRESENT LAW,<sup>1</sup> UNDER H.R. 13270,<sup>2</sup> AND PERCENT TAX CHANGE (ASSUMES NONBUSINESS DEDUCTIONS OF 10 PERCENT OF INCOME)

Adjusted gross income (wages and salaries)	Single person, 35 and over (widow or widower at any age)			Adjusted gross income (wages and salaries)	Single person, 35 and over (widow or widower at any age)		
	Present tax law	H.R. 13270 tax	Percent tax change		Present tax law	H.R. 13270 tax	Percent tax change
\$900.....	3 0	4 0	0	\$10,000.....	5 1,742	6 1,399	-19.7
\$1,700.....	3 115	4 0	-100.0	\$12,500.....	7 2,398	6 1,906	-20.5
\$3,000.....	3 329	4 175	-46.8	\$15,000.....	7 3,154	8 2,532	-19.7
\$4,000.....	3 500	4 331	-33.8	\$17,500.....	7 3,999	8 3,250	-18.7
\$5,000.....	3 671	4 501	-25.3	\$20,000.....	7 4,918	8 4,042	-17.8
\$7,500.....	3 1,168	6 957	-18.1	\$25,000.....	7 6,982	7 5,643	-19.2

<sup>1</sup> Does not include 10-percent surcharge.<sup>2</sup> Uses provisions effective for tax year 1972.<sup>3</sup> Uses minimum standard deduction of \$300.<sup>4</sup> Uses minimum standard deduction of \$1,100.<sup>5</sup> Uses 10-percent standard deduction.<sup>6</sup> Uses 15-percent standard deduction.<sup>7</sup> Itemizes deductible nonbusiness expenses.<sup>8</sup> Uses \$2,000 limit on 15-percent standard deduction.

TABLE 11.—EFFECT OF H.R. 13270 ON FISCAL YEAR RECEIPTS, 1970 AND 1971

(In billions)

	Fiscal year			Fiscal year	
	1970	1971		1970	1971
Tax reform provisions:			Other provisions:		
Corporation.....	+\$0.4	+\$1.1	Repeal of investment credit:		
Individual.....	+.3	+.6	Corporation.....	+\$0.9	+\$1.9
Total, tax reform provisions.....	+.7	+1.7	Individual.....	+.4	+.6
Tax relief provisions:			Total, repeal of investment credit.....	+1.3	+2.6
Corporation.....	-0	-1	Extend tax surcharge:		
Individual.....	-.7	-3.6	Corporation.....	+.3	+.7
Total, tax relief provisions.....	-.7	-3.7	Individual.....	+1.7	+.4
			Total, surcharge extension.....	+2.0	+1.1
			Extend excise taxes.....	+.5	+1.1
			Total, other provisions.....	+3.8	+4.8
			Total.....	+3.8	+2.8



